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Politics this week

May 19th 2005
From The Economist print edition

Bloodbath in Uzbekistan

AP

Many people, possibly hundreds, were killed when government troops opened fire on unarmed demonstrators in Andijan, a city in **Uzbekistan**. The United States said it was “deeply disturbed” by the actions of Islam Karimov's government. The unrest spread to a second town, Korasuv, also in the Ferghana valley, in the east of the country.

See article

The UN's World Food Programme said that **North Korea** was in urgent need of more food aid. The warning came as North and South Korea held their first talks in almost a year. But there is still no sign of a resumption of the six-country negotiations on North Korea's nuclear proliferating: South Korea is promising to table new proposals if the North returns to the talks.

Japan's parliament approved a law renaming a public holiday, April 29th, in honour of its late emperor, Hirohito. Many in China and South Korea will feel that this glorifies Japan's military past.

India's railways minister, Laloo Prasad Yadav, was charged with embezzling more than $600,000 when he was chief minister in the state of Bihar.

Pakistan's opposition was outraged by suggestions from an official spokesman that President Pervez Musharraf may seek to stay in power after his term expires in 2007.

See article

Nuclear power play

Iran's conservative-dominated parliament demanded a resumption of uranium-enrichment work that Britain, France and Germany have been trying to persuade the country to abandon. If talks next week produce no compromise that suits them, Iranian officials have said that enrichment-related work will start anyway.

Sectarian tension in **Iraq** rose, with a leading Sunni clergyman accusing an armed wing of a Shia party in the new government of a campaign to assassinate Sunni preachers, several of whom were murdered this week.

See article

A court in Riyadh sentenced three dissident liberals who had called for **Saudi Arabia** to become a constitutional monarchy to prison terms of between six and nine years.

See article

Kuwait's parliament gave full political rights to women, enabling them to vote and run for office in elections; but they will have to “abide by the laws of Islam”—which men are not obliged to do.

Egyptian security forces arrested 56 people thought to be connected to the Muslim Brotherhood, which

is banned but had been tolerated.

Ethiopia held its fairest election ever, though there were credible reports of harassment and intimidation of the opposition. The ruling coalition claimed victory before the vote count was complete. So did the opposition.

AP

See article

Congo's unelected parliament adopted a new constitution. Riots started as it became clearer that elections due by June 30th will be delayed.

Crunch time

The fate of **Canada's** Liberal government hung in the balance as Parliament was due to hold a vote of confidence on May 19th. A last-minute defection to the Liberals of a leading Conservative bolstered the government's chances.

See article

Growing protests in **Bolivia** over a new energy law threatened to topple President Carlos Mesa.

See article

The United States arrested Luis Posada Carriles, a **Cuban exile** sought in connection with the bombing of a Cuban airliner in 1976. Earlier, Fidel Castro led a demonstration of thousands in Havana demanding Mr Posada's arrest as part of the war on terror. Mr Posada denies the charges.

Brazil, Germany, India and Japan began circulating a draft resolution calling for an expansion of the number of seats on the UN **Security Council** from 15 to 25, including six new permanent ones, four of which they hope to secure for themselves.

Angelenos for Antonio

Antonio Villaraigosa won the run-off in the **Los Angeles** mayor's race with 59% of the vote. He is the first Latino mayor of America's second-largest city (whose population is now 47% Latino, and rising) for 133 years.

See article

At a Senate committee hearing on the Iraq oil-for-food scandal, **George Galloway**, a maverick British member of parliament, denied that he had received money from oil allocated by Saddam Hussein's regime.

See article

Harvard University unveiled plans to spend $50m over the next ten years to recruit more female scientists and faculty from minority groups. Lawrence Summers, the university's president, said the proposals would make Harvard “more welcoming”.

The **Federal Reserve** announced the retirement of Edward Gramlich from its seven-member board of governors. He follows Ben Bernanke, who was chosen last month to head the Council of Economic Advisers. Meanwhile, it was reported that the White House wants the Fed's chairman, Alan Greenspan, to stay on beyond the end of his term on January 31st 2006.

Newsweek, an American magazine, retracted a report that guards at **Guantánamo Bay** had thrown a Koran into a toilet. The report provoked riots in several Muslim countries, resulting in deaths.

See article

Russian justice?

AFP

The judges began reading their verdicts in the trial of the Russian oligarch, **Mikhail Khodorkovsky**, former boss of Yukos, Russia's largest oil company. Although the reading was spread over several days, all the signs were that their answer would be guilty on all counts.

See article

Spain's parliament passed a motion supporting the idea of government negotiations with ETA, so long as the Basque terrorist group abandons violence. But two days earlier, ETA set off four bombs, casting a shadow over any chance of peace talks.

See article

France was in confusion over whether May 16th should be a holiday. The government originally scrapped the holiday to raise money for the elderly—but many people decided not to go to work anyway.

See article

The French campaign for the May 29th referendum on the **European Union constitution** officially kicked off. The European Commission president, José Manuel Barroso, said rejection would have dire consequences. The latest polls suggest that the result could easily go either way.

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Business this week

May 19th 2005
From The Economist print edition

Morgan Stanley verdict

Morgan Stanley, already beset by strife among its top managers, faced more bad news. The investment bank was ordered by a Florida court to pay a total of $1.45 billion in damages to Ronald Perelman. Jurors were directed to find that the billionaire investor was deliberately misled about the financial position of Sunbeam (a maker of household appliances that eventually went bankrupt) in a 1998 deal. The bank will appeal.

See article

In Germany's largest-ever private-equity deal, an arm of **Terra Firma Capital Partners**, a British firm, bought Viterra, the property unit of E.ON, a utility. The €7 billion ($8.8 billion) deal comes during a heated debate in Germany over the impact of foreign investors on business.

HSBC confirmed that it is in talks to take a majority stake in Dar Es Salaam Investment Bank of Iraq. Iraq had banned foreign banks for 35 years.

BP issued a preliminary report on an explosion at its refinery in Texas on March 23rd, which killed 15 people and injured more than 170 others, and admitted that a “series of failures” led to the disaster. Analysts are waiting to see how much claims for compensation and lawsuits will cost the firm.

Not missing Carly

Hewlett-Packard reported a 9% rise in net profit for the quarter ending April 30th, compared with a year ago; operating profit in the company's printer business fell by 14%. Mark Hurd, who became CEO in April, said he would soon produce plans to make the computer manufacturer more competitive through cost-cutting measures. Hewlett-Packard's chief rival, **Dell**, recently posted a 28% increase in its net profit for the quarter.

Vivendi Universal, a French telecommunications and media group, launched a lawsuit against **Deutsche Telekom** for €2.2 billion ($2.8 billion). Vivendi claims that Telekom unlawfully terminated negotiations last year on a 51% stake in Polska Telefonia Cyfrowa, central Europe's largest mobile-phone operator.

Microsoft, Sony and Nintendo announced their next-generation **video-game consoles** at a conference in Los Angeles. Microsoft's Xbox 360 will go on sale later this year—Sony's PlayStation 3 and Nintendo's Revolution should follow in 2006. All three promise games of near-photographic realism and support for online play.

EasyJet announced the early retirement of Ray Webster, its chief executive for nine years. Stelios Haji-Ioannou, the low-cost airline's founder and main shareholder, was invited to rejoin the board after an absence of three years.

It was reported that **US Airways** and **America West Airlines** were close to finalising a planned merger. The deal is seen as vital to keeping US Airways afloat. Since 2001 it has twice sought bankruptcy protection.

See article

Air France KLM posted its first full results as a merged company. The airline made a net profit of €351m ($445m) for the year ending March 31st.

Toyota confirmed plans to build its first gas-electric car outside Japan. Around 48,000 Camry hybrids will be made in the first year of production, starting in late 2006, at its plant in Kentucky.

Deere & Co, the world's largest tractor manufacturer, reaped the benefit of higher American farm incomes and posted a 27% rise in net profit, to $604m, for the quarter ending April 30th, compared with the same period in 2004.

Escalating the war of words

America toughened its position against China's policy of pegging the **yuan** to the dollar, which is believed to hurt American exports. The Treasury issued a report stating that unless China took significant remedies within the next six months, the country would be designated a “manipulative trade partner”.

See article

America's commerce secretary, Carlos Gutierrez, said that an investigation into the surge of **textile imports** since the start of the year had concluded that quotas should be reintroduced on trousers, shirts and underwear from China. The quotas are expected to start at the end of May, before negotiations.

Pascal Lamy, who last week won the race to be the next director-general of the **World Trade Organisation**, said that concluding the Doha round of trade talks was “objective number one, number two and number three”. The talks have been stalled by difficulties in reaching agreement on farm subsidies and services.

See article

That's better

Japan's GDP grew at an annualised rate of 5.3% in the three months ending on March 31st. The increase beat most forecasts, and was explained by a rebound in private consumption, up 1.2% from the last three months of 2004.

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American capitalism

Damaged goods

May 19th 2005
From The Economist print edition

The American economic model is doing all right. It could be doing even better

LOOKING around the world, you do not see many economies, least of all rich ones, doing as well as America's. In the inexhaustible capacity of its private sector to innovate, in its seemingly unquenchable desire to reinvent itself, the United States still leads the world, and reaps the material rewards of that leadership. Its brand of capitalism appears to have something going for it—so it may seem churlish, even perverse, to wonder how much better a country as successful as this might do if it really tried. And yet it could indeed be doing better. That's right: American capitalism is not beyond improvement.

In 2001-02, at the height of the Enron scandal, and amid the other corporate debacles that stained the reputation of American business, that would have seemed too obvious to be worth stating. But concerns about corporate probity have receded of late. This is for a variety of reasons. One of them, or so its designers hope, was the Sarbanes-Oxley statute, the measure conceived in response to those scandals. But that law is not in fact proving to be the unalloyed blessing that its creators envisaged. Meanwhile, other flaws in the American business model remain unattended to; they were simply not addressed by SOX (as it is now, not always affectionately, known). So, pleasant though it must be for the United States to contemplate the current performance of the continental European alternative, it would be wrong, as well as unAmerican, to be complacent. There is still some work to do at home.

Repent at leisure

The trouble with Sarbanes-Oxley is that it was designed in a panic and rushed through in a blinding fervour of moral indignation. This is not to say that the problems it addressed were imaginary. The calamities at Enron, WorldCom and the others warranted remedial action. And accounting failures—the focus of SOX's efforts—were undoubtedly among the things that went wrong. But it would be difficult to argue that mere book-keeping was the main thing. Yes, it is outrageous that the true state of those companies was disguised. But when firms collapse that way, it is usually because they have borrowed too much and squandered the money. Accounting impropriety may conceal those errors, for a time, but is hardly ever the main cause. Bad business judgment, with or without criminal intent, is far more often to blame. And bad economic policy can sometimes contribute to bad business judgment.

Sarbanes-Oxley was right to attack the long-recognised conflict of interest in the audit profession, and to put some distance back between a company's auditors (who are there to safeguard shareholders' interests) and its managers (who sometimes forget that that is their job too). This needed to be done,

and in fact the act might have gone even further in this respect. But the statute, carried along by rage and by the desire of Congress to do something dramatic, ranged wider than was necessary to achieve that particular goal. Its daunting requirements on managers, with the threat of severe criminal penalties to back them up, are imposing substantial costs, direct and indirect, on American business (see article).

The book-keeping industry, having been fingered (wrongly) as the main culprit in the great scams of recent years, is suddenly elated: thanks to Congress, its incomes are soaring. On the other hand, many of the men actually running American business, not all of them robbers or frauds, are dismayed. Congress has made their job harder—and, ultimately, it is the economy at large that will bear the cost. Fortunately, some of this excess burden is already being lightened, as calls for a less rigid interpretation of the law are heeded. More “flexibility” of that sort, as it is called, would be welcome.

A world beyond audit

The rest of a suitably ambitious agenda for improving the performance of American capitalism might run as follows: genuine, as opposed to phoney, corporate-governance reform; tort reform; tax reform; and corporate-welfare reform. The Bush administration seems to be keen on some parts of this package, but is decidedly opposed to others.

The challenge for corporate-governance reformers is easily stated: to hold managers more accountable to shareholders. However, one can only expect so much of auditors, with or without SOX, or regulatory agencies, of which America has no lack. It would be more fruitful to pay attention to the market for corporate control. Nothing is better calculated to make managers concentrate on pleasing the owners than the threat of a possible takeover. Policy should aim to invigorate this market—whereas at present, through an unplanned accretion of statutory and judicial interventions, it does the opposite.

The Bush administration rightly advocates tax reform and tort reform, both of which are needed to iron out mangled economic incentives. But advocacy is no substitute for action. The tax system cries out for radical simplification—which is apparently not what Mr Bush intends. Recent changes to the taxation of dividends have helped to lessen the tax code's bias in favour of borrowing, but this harmful distortion has by no means been removed. It is one of the main ways in which policy leans on households and businesses to take bigger financial risks than they would if left to their own devices.

A fine way to deal with this would be to cut corporate taxes (against which debt service can be deducted, hence the pro-debt bias); and an excellent way to pay for that would be to launch an assault on corporate welfare—the $100 billion a year or so, conservatively estimated, of special-interest subsidies and handouts that the government pays to American businesses. Preferably, don't just cut that lot, eliminate it.

This last recommendation is one that George Bush will be especially reluctant to accept. Mr Bush is the classic instance of a conservative politician who confuses support for particular businesses with support for enterprise in general. These seemingly similar ideas are in fact directly contradictory. The way to support enterprise—American enterprise, the best in the world—is to be as unEuropean as possible. Mr President, look at France. Notice their economic policies. See how they subsidise this and protect that. Do we have to spell it out?

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China's currency

Time to let go

May 19th 2005
From The Economist print edition

AFP

China should loosen its currency peg—and quickly

TEMPERS about China's currency are fraying on both sides of the Pacific. In America, the Bush administration this week branded China's currency policies as “highly distortionary” and made clear that it wanted to see a “substantial alteration” within six months. Coming amidst the reimposition of quotas on imports of some Chinese textiles and with rising anti-Chinese fervour on Capitol Hill, the American message to China is clear: do something about the yuan fast, or risk a protectionist backlash.

In Beijing, Wen Jiabao, China's prime minister, has been equally blunt. China's currency, he argued this week, was an issue of “China's own sovereignty”. “Any pressure or effort to politicise an economic matter,” he warned, “will not help solve problems.” In other words, shut up and leave us alone.

Mr Wen's irritation is understandable. Most congressmen use few facts and even less logic in their anti-Chinese rants. A stronger yuan would not, as many of them appear to believe, magically erase America's trade deficit (see article). And Mr Wen is right that China's currency policy should be determined by what is best for China. Where he errs is in his apparent conclusions. Economic and political considerations point the same way: China should loosen the yuan's peg, and soon.

Past its prime

The yuan has been pegged at 8.28 to the dollar since 1995. For much of that time the policy served China well. A stable currency underpinned the country's booming economic growth—and earned Beijing international plaudits when other Asian currencies plunged during the late 1990s. In recent years, however, it has become a liability, creating ever greater distortions within China's economy. Most important, the currency peg prevents China from running an appropriate monetary policy. In effect, Beijing has been forced to import America's easy-money posture, whereas China's overheating economy called for tightening. The result has been some enormous financial imbalances. Although consumer prices are rising only modestly, there are signs of faster increases in the prices of industrial goods and assets. The booming coastal property market signals an economy awash in cash.

Beyond these distortions, evidence is mounting that the yuan is becoming increasingly undervalued, which itself has a cost: too many resources are allocated towards exports and too few to domestic demand. China's current-account surplus is rising sharply: from 1.5% of GDP in 2001 to 4.2% of GDP in 2004. Some forecasts for 2005 are much higher still.

The demands of macroeconomic management and the need for balanced growth both suggest the currency regime needs to change. The question is how. China needs a currency system that will not just ease today's distortions but will allow it to cope with a turbulent few years ahead, as America's huge deficits eventually send the dollar down farther.

The boldest move would be for Beijing to simply let the yuan float, albeit in a managed kind of way. That is much less radical than it sounds. A more flexible currency would not force China to abandon its capital controls. Although many people—including American and Chinese government officials—tend to talk about a floating currency and free capital flows as though they were the same, there is no reason to lump the two together. Currency flexibility can, and probably should, come first. With a managed float, the Chinese could focus on domestic monetary policy, while intervening enough to stop disruptive swings in the yuan.

Weighing the dangers

The difficulty is that after a decade of a tight peg, China's banks, firms and politicians are terrified of the uncertainty of a float. Given this timidity, China could replicate much of the flexibility of a managed float by shifting the yuan's peg from the dollar to a basket of currencies, at the same time widening the band within which the yuan can fluctuate, say to 10% above or below the peg. Beijing must also decide how big an appreciation, if any, should accompany the shift. Here, too, Chinese caution suggests a modest revaluation is most likely. Again, such timidity is misplaced. A small appreciation would probably worsen China's monetary predicament by increasing the size of capital inflows, as investors bet on more appreciation down the road. Better to squelch the speculators by choosing a substantially stronger yuan early on.

The economic risks in abandoning the peg are smaller than many in Beijing believe. China's financial sector is fragile—but that simply suggests it would be foolish to rush towards full capital mobility. The government would lose money on its huge stash of foreign-exchange reserves—but that loss will occur whenever the yuan appreciates and will be bigger the longer today's system continues. It is true that an appreciation might modestly and temporarily slow China's growth as the economy changes gear—but, since China's exports contain lots of imported inputs, it is hard to see even a double-digit yuan appreciation sending exports into a tail-spin.

Today's economic risks may be modest, but they will grow if China's government continues to delay. The political risks will mount as well. Washington's protectionist rhetoric is no idle threat: America's behaviour towards Japan in the mid-1980s shows that tub-thumping in Congress can quickly lead on to real protectionist action. Delay also adds to the dangers for the global economy. By showing bold leadership now, China could start the much-needed adjustment of global economic imbalances.

A stronger yuan would allow Asia's other emerging economies to let their currencies rise. A slower pace of Chinese reserve accumulation might nudge America's long-term interest rates higher—exactly what is needed to curb American consumption. Only if financial markets panicked would interest rates soar enough to cause a serious crash. And that kind of panic becomes more likely as the imbalances grow and the political temperature rises. To avoid all this, help its own economy and, once again, win plaudits for economic statesmanship, China should loosen the yuan peg, and do it now.

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Italy

The real sick man of Europe

May 19th 2005
From The Economist print edition

Italy's economy is stagnant, its businesses depressed—and its reforms moribund

Get article background

IT WAS Tsar Nicholas I of Russia who reputedly coined the phrase, to describe the Ottoman empire. Since then, many other countries have been called “the sick man of Europe”. In the 1960s and 1970s, a strike-prone, slow-growing Britain was the favourite. In the 1990s the title passed to Germany. Now a new patient has emerged: Italy.

For a while, the country's ills have seemed merely part of those of the wider euro zone, whose poor performance has reflected the sluggishness of its three core economies, Germany, France and Italy, which account for 70% of euro-area GDP. All three suffer from Europe's familiar troubles of excessive labour- and product-market rigidities, too high public spending and taxes, and too much regulation. Yet last week's news that Italy fell back into recession in the first quarter of 2005, while France and Germany picked up, suggests that Italy has even graver problems than the bigger two.

Those problems are spread wide across the economy, business and politics. As this week's OECD report on Italy highlights again, the country's slow economic growth mainly reflects its structural failings. The miracle years of the 1950s and 1960s created an economy that depended heavily on small manufacturing firms, many of them concentrated in the north and in such specialist areas as textiles, furniture, machine-tools, food-processing and white goods. Such companies needed a low cost-base to sustain competitiveness; in times of inflation, this was secured by devaluations of the lira. That get-out is no longer available now that Italy is using the euro.

It also happens that these industries are the ones most vulnerable not just to competition from the rest of Europe, but increasingly from Asia, notably China. It is no surprise that Italy's textile firms are in the forefront of those demanding new protection from Brussels against Chinese exports. Makers of furniture and white goods are suffering similarly. And Italian companies are losing market share to Chinese rivals not just in Europe but in world markets too.

No wonder businessmen in Italy are feeling ever more pessimistic. Even as they struggle to cope with a somnolent economy, they can also point to a string of recent steps that have undermined their own confidence as well as that of foreign investors (see article). Things began to go visibly wrong two years ago when trouble (still unresolved) erupted at Fiat, the country's flagship carmaker, and when Italy's

retail banks arrogantly sold high-risk bonds to their customers as if they were safe. The bonds were issued by Argentina and by two Italian firms, Cirio and Parmalat. The country defaulted, while the two food groups went bust. The fraud that brought down Parmalat showed that Italy's system of corporate governance was rotten. The regulatory response, though quick at first, became sluggish once politicians thought a crisis had been averted. Although Parmalat has been rescued, prosecution of those who nearly destroyed it has been less than zealous.

Corporate governance continues to suffer big reverses, none bigger than the ousting last week by the government of Vittorio Mincato, boss of Eni, the world's sixth-largest oil-and-gas company. Not only was this talented and apolitical manager replaced by somebody who knows nothing of the industry (Paolo Scaroni, boss of Enel, Italy's electrical utility); but also that ignorance is now shared by Eni's entire board. The political nature of Mr Scaroni's appointment suggests that the government considers any company in which it holds a stake as essentially state-owned and therefore susceptible to political direction. This reverses a slow trend for such companies to become independent of the political graft and favours that once made Italy pay a big premium to borrow in international markets. Mr Scaroni now has a chance to prove that he can resist political interference, just as Mr Mincato did. But Eni's shareholders will be watching nervously to see how the company behaves under its new management. Similarly, foreign investors are waiting to see whether the extraordinary saga of two attempted takeovers of Italian banks by foreign ones ends happily (ie, the foreigners win) or in farce. At this point, the outcome remains hazy, but the Bank of Italy and Consob, Italy's stockmarket regulator, have so far displayed a disturbing mixture of protectionism and sloth.

Where is the government?

Italy's poor performance has not only damaged business; it has also undermined living standards. That is the main reason Italians are turning away from the centre-right coalition led by Silvio Berlusconi that has been in office since 2001. Although Mr Berlusconi got better news from local elections in Sicily this week (see article), other recent elections have confirmed that his government is now deeply unpopular.

The Economist made no bones about its views of Mr Berlusconi in 2001: we argued that he was unfit to be prime minister of Italy (see article). Our case focused on his long history of legal entanglements, plus the jarring conflicts of interest that he faced from being in charge of the government (and so, indirectly, its public television) while controlling almost all of Italy's private television stations. Yet even we conceded one hope: that the businessman-turned-politician might bring in the economic reforms Italy needed and get a grip on the public finances.

Four years on, the Berlusconi government has failed to do even this. Distracted by legal matters, dependent on his fractious coalition partners, Mr Berlusconi has delivered too few reforms (though his personal business interests have prospered). His cure for Italy's public finances has been mostly one-off measures such as tax amnesties; the budget deficit is now ballooning again. He has managed to cut taxes a little, but nothing like as much as he once promised. He has made some changes to pensions and social security, but in general his reform efforts have been too little, too late. And the really bad news is that, were Mr Berlusconi to lose the general election due next spring, the centre-left opposition, led by Romano Prodi, a former prime minister and ex-president of the European Commission, appears not to have any more dynamic economic policy or reforms to offer. Italy's new title could go unchallenged for quite a while.

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Supporting Uzbekistan's dictator

Unwise, and curiously planned

May 19th 2005
From The Economist print edition

Relying on a despot like Islam Karimov was always going to be dangerous

THE “realist” school of diplomacy has always held that a regime's record on human rights is only one of a number of factors that should condition a democratic government's attitude towards it—and by no means the most important one. Geographical position, access to oil or other resources, the potential for trade, usefulness in the struggle against communism or fundamentalism: all these must be taken into account before giving in to the righteous anger to which the realists' mortal enemies, the “idealists”, are so prone. Even powerful countries like America, after all, must exist in the real world, and it is not hard to argue that it is in their overwhelming interest to maintain harmonious relationships with countries such as Saudi Arabia and China, while making occasional pro forma protests against their more barbaric practices.

So there has been a case to be made for America and its allies dealing leniently with Islam Karimov, the Soviet-era holdover who has oppressed Uzbekistan since well before its independence in 1991. When, in the late 1990s, he started locking up thousands of political prisoners for belonging to a range of Islamic organisations, criticism in the West was muted by the fear that a genuinely troublesome movement was trying to create an Islamic caliphate in Central Asia, centred on the lands of Tamerlane. His willingness to offer America and Britain an air base after the attacks of September 11th 2001 made him only the more useful, even as he intensified his efforts to ban all forms of opposition. The fact that Uzbekistan sits on large gas reserves was also of some significance—though getting the stuff from Central Asia to world markets is far from easy. In 2003, the European Bank for Reconstruction and Development went so far as to honour Mr Karimov by holding its annual meeting in his capital, Tashkent.

On May 13th, Mr Karimov showed the world his true colours (see article). It may be months, if ever, before a full account of what went on in Andijan is available, but it seems clear that the authorities there put down a popular uprising with extreme brutality. Hundreds of people appear to have died: witnesses say that soldiers were still shooting at the wounded three hours after the first shots were fired. This was probably the worst atrocity conducted by a government against protesters since Tiananmen Square in 1989.

Hard-headed realists should now be appalled. Even on the most self-interested calculus, the reality is that Mr Karimov is an ally the West is better off without. His help in the war against terror is outweighed by the encouragement he has given to radicals of every stripe in Central Asia and beyond, and by the damage that association with him does to the West's reputation. This was true even before Andijan: by far the best recruiter for the Islamic Movement of Uzbekistan (the main organisation that has been trying to destabilise Central Asia since the 1990s) has been Mr Karimov himself. Anyway, the movement was largely destroyed in 2001 when the Afghan war toppled the Taliban, which had protected it. Nor is Uzbekistan of real strategic importance any more. With bases in Kirgizstan and Afghanistan, America hardly needs Khanabad, the base for which it pays Mr Karimov handsomely. He should now be made a pariah, his regime stripped of all forms of aid, and all military assistance withdrawn. When he is overthrown, as sooner or later he will be, whoever succeeds him will have little reason to love the West. But encouraging regime change would be a way to start providing one.

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America's Latinos

The torch has passed

May 19th 2005
From The Economist print edition

EPA

A victory in Los Angeles offers a chance for reflection for America's biggest minority

IN THE end it was a much larger victory than most had expected. Antonio Villaraigosa stormed through the run-off election to be mayor of Los Angeles, beating the incumbent James Hahn by 59-41%. Mr Villaraigosa is the first Latino mayor of America's (now) second-largest city since Cristobal Aguilar left office in 1872, back when Hollywood was a dusty field.

It is not an enviable job. Los Angeles has appalling schools, a troubled police force and the worst traffic in the country—and the mayor has precious little control over any of these things. Yet for America's largest minority—Latinos have just passed blacks—Mr Villaraigosa's election is hugely significant.

There have been Cuban mayors of Miami; Latinos have been elected to Congress, headed the armed forces and served in the cabinet; Bill Richardson, who is partly Mexican, is governor of New Mexico. But Los Angeles is the biggest prize so far. Some of Mr Villaraigosa's critics think he has more charm than substance. But he also represents a new generation of leaders who are determined to make Latinos a more potent political force. Indeed, many wonder why it has taken so long for a group that accounts for 47% of LA's population to take the top job.

To make a success of it, Mr Villaraigosa and his peers will have to tackle two thorny questions: race and immigration. With the former, the challenge, put crudely, is to avoid the mistakes made by blacks. Black politics—for reasons that are as understandable as they are regrettable—has been dominated by race. The black political establishment remains wedded to outdated race-based policies such as affirmative action (ie, positive discrimination); blacks have also allied themselves as a voting block with the Democratic Party, usually voting Democrat by margins of close to nine to one.

Most Latino politicians, including Mr Villaraigosa, support affirmative action. It is to be hoped that this is just posturing. In a state as gloriously miscegenated as California, doling out university places and building contracts according to varieties of skin tone is dangerous. It is far better to target help on the basis of people's income (something which, in places like Los Angeles, would mean helping Latinos anyway). Mr Villaraigosa will not be judged as mayor by how many plum jobs Latinos land at City Hall, but by how much better the schools and roads get. It is a good sign that he is keeping on at the LAPD Bill Bratton—the man who helped reform New York's police department.

It is also encouraging that the Democratic Mr Villaraigosa received support from some Republicans—notably a former mayor, Richard Riordan. Although they still vote mainly Democrat, Latinos take a

conservative line on plenty of issues, notably abortion. George Bush won two in five Latino votes last year. This is a healthy sign of assimilation and also canny politics; as long as they remain “in play”, Latinos will be wooed by both parties.

That brings in the second thorny issue: immigration. Many Californian Latinos turned against the Republicans in 1994, when the latter sponsored Proposition 187, which tried to withdraw benefits from illegal aliens. Once again, fury about illegal immigrants is mounting on the right—with predictable posturing about trying to close the border. This looks impractical: California's fields and kitchens would empty. But Latinos too need to accept that the current situation, where 10m people live in the country illegally and 200 get killed crossing the Arizona desert each year, is dangerous and unacceptable; and that attempts to fix it should not just be automatically rejected as racially biased.

Some form of compromise whereby current illegal workers are granted temporary work permits in exchange for tougher rules in the future makes sense. A bipartisan bill doing just that has been proposed by Ted Kennedy and John McCain (see article). So far, Latinos have hardly rushed to endorse it. Now would be a good time for them to start. In the meantime, Mr Villaraigosa has a lot of roads and schools to fix.

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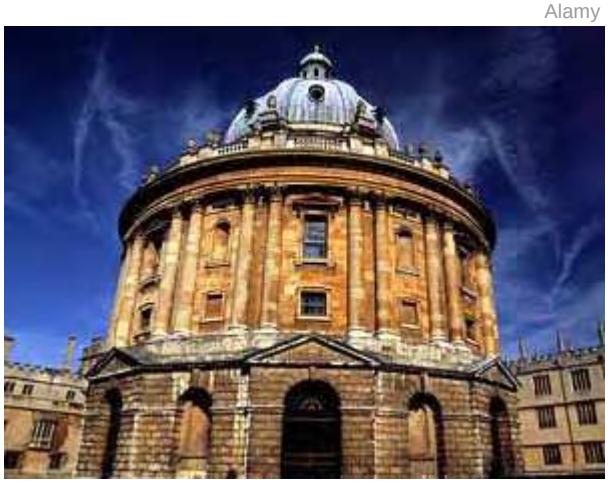
British higher education

Free Oxford University

May 19th 2005
From The Economist print edition

Alamy



The row going on in Oxford is passionate but beside the point

Get article background

IT MAY be just as well for Oxford University's reputation that this week's meeting of Congregation, its 3,552-strong governing body, was held in secret, for the air of civilised rationality that is generally supposed to pervade donnish conversation has lately turned fractious. That's because the vice-chancellor, the nearest thing the place has to a chief executive, has proposed the most fundamental reforms to the university since the establishment of the college system in 1249; and a lot of the dons and colleges don't like it (see article).

The trouble with Oxford is that it is unmanageable. Its problems—the difficulty of recruiting good dons and of getting rid of bad ones, concerns about academic standards, severe money worries at some colleges—all spring from that. John Hood, who was recruited as vice-chancellor from the University of Auckland and is now probably the most-hated antipodean in British academic life, reckons he knows how to solve this, and has proposed to reduce the power of dons and colleges and increase that of university administrators.

Mr Hood is right that the university's management structure needs an overhaul. But radical though his proposals seem to those involved in the current row, they do not go far enough. The difficulty of managing Oxford stems only partly from the nuttiness of its system of governance; the more fundamental problem lies in its relationship with the government. That's why Mr Hood should adopt an idea that was once regarded as teetering on the lunatic fringe of radicalism, but these days is discussed even in polite circles. The idea is independence.

Oxford gets around £5,000 ($9,500) per undergraduate per year from the government. In return, it accepts that it can charge students only £1,150 (rising to £3,000 next year) on top of that. Since it probably costs at least £10,000 a year to teach an undergraduate, that leaves Oxford with a deficit of £4,000 or so per student to cover from its own funds.

If Oxford declared independence, it would lose the £52m undergraduate subsidy at least. Could it fill the hole? Certainly. America's top universities charge around £20,000 per student per year. The difficult issue would not be money alone: it would be balancing numbers of not-so-brilliant rich people paying top whack with the cleverer poorer ones they were cross-subsidising. America's top universities manage it: high fees mean better teaching, which keeps competition hot and academic standards high, while luring

enough donations to provide bursaries for the poor. It should be easier to extract money from alumni if Oxford were no longer state-funded.

A worked example

The government could help or hinder this plan. If it were feeling vengeful, it could cut Oxford's research money, currently £150m, as well as the subsidy to undergraduates. The instincts of most Labour politicians—including Gordon Brown, the chancellor, who has had a dust-up with Oxford over its supposed elitism—would be to stand in the way of independence. But Tony Blair might just take a different view. Last year he forced higher tuition fees through Parliament because he believed that making the middle classes pay for more of their university education would be both fairer to poor people and better for universities. If Oxford went all the way, charged well-off people the full cost of their degrees, and flourished academically and financially as America's top universities have done, then it would prove his point.

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Letters

May 19th 2005
From The Economist print edition

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Colombia's paramilitaries

SIR – Your article on Colombia's right-wing paramilitaries attributes several positions to the government of Colombia that do not correspond with reality ("Politics, drugs and the gun", April 30th). For instance, you state that "Congress amended the amnesty bill to deny the paramilitaries the right to stand for office. [President Álvaro] Uribe is trying to change that". Mr Uribe has been emphatic in his opposition to the possibility of amnesty or pardons for drug-trafficking or for crimes against humanity (such as kidnapping, massacres or homicide). This is established in the constitution and by international treaties. The government did propose that the crime of sedition should be treated as a political offence (similar to rebellion by the guerrillas), but only for those who have not committed crimes against humanity and have demobilised.

You also claim that "although [the AUC] has frequently violated its ceasefire, Mr Uribe has turned a blind eye, while unleashing the army against the FARC." No government has combated the paramilitaries as much as this one has. The efforts by the military forces against these groups have been impressive. Since the beginning of this administration, 9,864 paramilitaries have been captured and 1,125 have been killed in combat. More than 7,000 have demobilised. This has directly resulted in the reduction of 68% of the homicides and 86% of the massacres attributable to these groups.

Jorge Alberto Uribe
Minister of defence
Bogotá, Colombia

Language barriers

SIR – One of the reasons why America faces a shortage of Arabic linguists is that quite a few highly qualified Arabic translators working for our security agencies were sacked ("Know thine enemy", May 7th). The reason? They were gay. In this country, national security takes a back seat to political point-scoring by pandering to our own homegrown brand of fundamentalist nuts.

Joe Judge
San Diego, California

Corruption in Indonesia

SIR – The author of your article on corruption in Indonesia referred briefly to "a high-profile investigation into billions of dollars in loans from the country's largest state bank, Mandiri, which quickly had to be written off as bad debts" ("Uprooting graft", April 30th). The attorney-general's office has publicly stated that their investigation is currently looking into five loans to four debtor companies. Our records show that the loans in question total approximately 584 billion rupiah ($61.5m). If your author is referring instead to a regular audit completed by the Supreme Audit Agency in October of 2004, that report commented on 12.2 trillion rupiah ($1.29 billion) of loans, of which 82.1% were performing as of December 2004. Bank Mandiri has been co-operating with the attorney-general's investigation, which has, to date, resulted in the detention of several executives from two debtor companies. We also support the government's ongoing efforts to eliminate graft and to tackle corruption.

K. Keat Lee

Chief financial officer
Bank Mandiri
Jakarta

Divine intervention

SIR – The Archbishop of Canterbury has some valid criticisms of free market liberalism that deserve our serious attention, not the three short paragraphs that constituted your full and damning critique of Anglican economics ("Who're you calling naive?", April 30th). One of the reasons why I enjoy reading *The Economist* is because you cut through the ideological crap and thus gain more insight into the issues being discussed. If you want to advocate free trade, then argue for it and avoid pontificating against people such as Rowan Williams who are concerned with the consequences for real people of political and economic policy. "Core competences" indeed.

Francis Sedgemore
London

SIR – The Anglican church has followers all over the world, many in poorer countries, and its head should be a voice for the voiceless. The Archbishop is calling for humility and an awareness that we should not follow blindly any one view. Perhaps the importance of his call was demonstrated by your arrogant response?

Brian Macallan
Cape Town, South Africa

SIR – May I suggest that your author has embraced neoclassical economics as a belief system? And may I further suggest that the author's anger stems from being challenged by a competing belief system? One last question: was Jesus over the line when he said "Woe unto you that are rich"?

Paul Hyer
Blakes, Virginia

Peru and Chile

SIR – Your article on Peru's relationship with Chile contains much misleading information ("Refighting a war", May 7th). Peru's citizens have different reactions to the arms sales made by both Argentina and Chile to Ecuador (when Peru and Ecuador were in armed conflict) because the Argentine president excused his country, categorising the deals as "criminal and aberrant". Chile has not presented appropriate excuses, despite admitting the sale of arms made while Augusto Pinochet was army chief. It is in this context that Peru cast a blank vote in the election for Chile's interior minister, José Miguel Insulza, as the new OAS secretary-general, and not as a result of territorial affairs, which you claim in another article ("Leading from the south", May 7th). Regarding the LAN-Peru airline video slandering the city of Lima, even Mr Insulza declared that "Peruvians have the right to feel insulted" and if the same thing had happened in his country, the Chilean people would have reacted in the same way.

Nor was there a different approach taken towards a Chilean-owned pasta factory in wetlands outside Lima compared with the treatment given to two American companies in the same area. The location of the former had a grave impact on the environment while the latter were not factories but merely used for storage. Finally, the different penalties given to two Chilean citizens and a Peruvian company for damaging historical monuments were because the Chileans acted intentionally, while the company's actions were accidental.

Luis Solari
Ambassador for Peru
London

Dirty prancing

SIR – I agree with the state representatives of Texas: "overtly sexually suggestive" routines by cheerleaders must be stamped out ("Has it come to this?", May 7th). Where do I apply for the post of "cheerocrat" to monitor such practices? Such is my stance on this subject I would be prepared to offer my services without charge.

Tim Kilpatrick
Blackpool, Lancashire

SIR – In the name of gender equality, Texas may want to consider a ban on football players from grunting and patting one another's behinds on the field. That too can be considered as overtly sexually suggestive.

Carolyn Bradley
Tallahassee, Florida

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The Khodorkovsky case

The tycoon and the president

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From The Economist print edition

AP

What Mikhail Khodorkovsky's downfall says about Russia's recent past, and its future

MISHA, as Marina Khodorkovsky refers to her son Mikhail, was always, she says, a fiercely determined little boy, whether he was learning to swim or looking for a holiday job. His childhood nickname was “Toy soldier”.

Her son's ruthless determination brought him a stunning career, one that exemplifies Russia's post-Soviet history: the opportunities, corruption and chaos of the Boris Yeltsin years; the disappointments and revanchism of Vladimir Putin's presidency; and the uncertainty of the future. Mikhail Khodorkovsky made more money more quickly than almost anyone in history. Then—somehow—he incurred Mr Putin's wrath. This week saw the culmination of his trial in a Moscow court for fraud, tax evasion, embezzlement and running a criminal organisation.

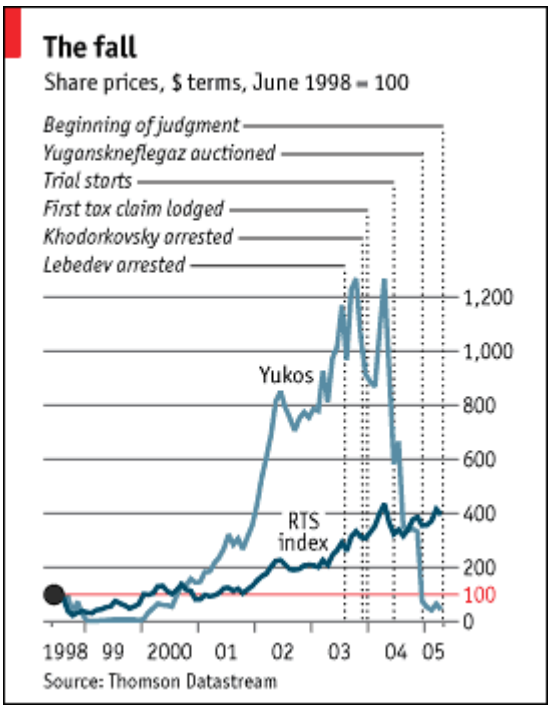
Russia's “oligarchs”—the small group of men who became ultra-rich in the years after communism collapsed—like to say that they are hated in their own country because, prejudiced by communist propaganda and Orthodox Christian asceticism, Russians do not yet understand the virtues of entrepreneurialism or the legitimacy of personal wealth. That is too kind an analysis of their unpopularity.

Like many who have prospered in post-Soviet Russia, though he came from a humble family Mr Khodorkovsky began with two advantages. He had a scientific background (and was thus less exposed than others to Soviet indoctrination); and, as an official in the communist youth league, he had powerful friends. As rules were bent and blind eyes turned in the Gorbachev era, legend has it that Mr Khodorkovsky found a way to convert hypothetical Soviet accounting units into cash, the cash into hard currency, and that into lucrative imports. He waded into the initial “voucher” privatisations of the early 1990s, which in theory were supposed to distribute the state's wealth fairly, and (in 1988) started a bank, which began to manage government money.

The bank also ran the rigged auction that led to Mr Khodorkovsky and his associates acquiring a majority stake in Yukos, which until recently was Russia's premier oil company. They got it in the gigantic scam known as “loans-for-shares”, in which great slabs of the Russian industrial base were sold to a small cabal of businessmen for a song. The motives for this crooked giveaway were mixed: an urge on the part of Mr Yeltsin's economic reformers to get state assets into private hands; the government's need for funds to see off the communist challenge in the 1996 elections; and sheer greed.

Loans-for-shares was perhaps not technically illegal; but as Andrei Illarionov, Mr Putin's maverick economic adviser, says, adapting Talleyrand, “worse than a crime, it was a mistake”. (He adds, though, that renationalisation of the ripped-off assets would be an even worse mistake.) The huge enrichment of a few insiders while most people struggled with poverty helps to explain why, for many Russians, democracy and the free market are still synonymous with corruption and inequality. If Mr Khodorkovsky and the other loans-for-shares participants helped to make a return to communism impossible, they are responsible also for the warped nature of Russian capitalism, and their country's disillusionment with reform.

Foreign investors with short memories are now bemoaning the demise of Russia's most “westernised” oligarch, which is what, when it suited him, Mr Khodorkovsky became. But that was only after he used every means at his disposal to take full control of Yukos. Especially after Russia's default-and-devaluation crash of 1998, some of the means were outrageous: squeezing out minority shareholders; moving important meetings at the last moment; hiding shares in offshore vehicles. There were rumours of worse.



Then, as his supporters now prefer to remember, Mr Khodorkovsky was the first of the Yeltsin-era tycoons to see that there was even more money to be made by going straight. Yukos started to keep western-style accounts and courted foreign partners. Oil prices rose; shares in Yukos, which was pumping 2% of global oil output, rocketed (see chart). Still in his 30s, Mr Khodorkovsky became, reputedly, the richest man in Russia. His career—from nothing to billions and then to prison—has the pure arc of a classical tragedy. This was its peak.

The over-reacher

Mr Putin's installation as president in 2000 was probably the real beginning of Mr Khodorkovsky's fall, though the new president was so opaque that his attitude to the uppity tycoons he inherited from his predecessor was not immediately clear. The downturn in Mr Khodorkovsky's fortunes became obvious in July 2003, when Platon Lebedev, his partner and now co-defendant, was arrested. Three months later, Mr Khodorkovsky himself was nabbed on a Siberian runway.

Almost immediately afterwards, Moscow discovered a new favourite parlour game: who's next? The game was hard to play, however, because nobody knew exactly what Mr Khodorkovsky had done wrong. The most popular theory was and is that he had violated a (possibly apocryphal) pact that Mr Putin struck with the oligarchs in 2000: they could keep what they had got in the 1990s if they paid their taxes and stayed out of politics. Mr Khodorkovsky and his associates funded several political parties, attempting what one Moscow banker describes as an “aggressive takeover of the Duma”, the lower house of Russia's parliament. There were whispers of a Khodorkovsky run for the presidency or other high office. In this analysis, a concerted effort to sway policy over energy taxes in June 2003 was the final straw.

But there are other plausible explanations. Given the oligarchs' unpopularity, it was politically expedient for Mr Putin to swing one from a lamp-post. As the very richest, swinging Mr Khodorkovsky would be especially symbolic. Or it may have been his plans to build a private oil pipeline to China that grated most. Or the Kremlin may have been alarmed by talk of a deal between Yukos and a big American oil company, after the planned (now cancelled) merger of Yukos with Sibneft, another oil firm controlled by Roman Abramovich, the owner of London's Chelsea Football Club. Mr Khodorkovsky also clashed publicly with Mr Putin over government corruption in February 2003.

Probably there was no single motive for destroying Mr Khodorkovsky. One that seems to have emerged along the way is the renationalisation of Yukos—and thus the strengthening of the government's control over the country's energy sector.

After Mr Khodorkovsky's arrest, many western fund-managers in Moscow told anyone who would listen that the problem was merely a private contretemps between the tycoon and the president, from which Yukos would emerge unscathed. They were wrong. A parallel campaign against the company soon began, in the form of vast claims and penalties for allegedly unpaid taxes, eventually amounting to around $28 billion; for one year, Yukos is said to owe more than it took in revenues. The basis for the claims was the purportedly illegal exploitation of regional tax-incentive schemes.

Mr Putin said repeatedly that there would be no renationalisation of privatised firms on his watch. But by freezing the company's bank accounts and setting impossible deadlines, the tax authorities and courts ensured that Yukos's tax bills were unpayable. Last December, in a transaction surreal even by Russian standards, Yuganskneftegaz, Yukos's main production arm, was forcibly sold in another rigged auction, to a front company registered at a provincial grocery shop.

The Russian government apparently came up with this ruse—“the swindle of the year”, as the loose-lipped Mr Illarionov called it—after Yukos tried to protect its assets by filing for bankruptcy in America. The origin of the $9.35 billion paid for the subsidiary is still a mystery, but the firm ended up in the hands of Rosneft, a state-owned oil firm. If Yukos's remaining assets go the same way (as looks likely), there will be nothing left of the company for the other shareholders who believed in Mr Khodorkovsky's transformation and bought in.

Rosneft's acquisition of Yuganskneftegaz, meanwhile, has derailed plans to merge the oil firm with Gazprom, the state-controlled gas giant (finally and farcically cancelled this week, though the government came up with another plan that would remove restrictions on foreign ownership of Gazprom shares, a move designed to alleviate some of the pain caused by the Yukos fiasco). The wrangling over the terms of the merger—and over which group of Kremlin henchmen ultimately gets control of Yugansk—vindicates those, including Mr Khodorkovsky, who maintain that the real explanation for the Yukos affair was always the simplest and most obvious one: graft.

The debacle of the auction confirmed the first big lesson of the long, meandering campaign against Mr Khodorkovsky and his company: that Mr Putin's regime is worryingly tactical, changing its methods and even its aims as obstacles that it ought to have anticipated present themselves. This amateurism has infected economic policy, over which the cabal of *siloviki* (roughly, “power people”) around Mr Putin, himself a former KGB officer, has come to exert a destructive influence.

The result has been queasiness among investors, falling stock prices and rising capital flight. Whatever the moral case for revisiting the privatisations—and it was a strong one—this was not the way to go about it. After Yukos, conciliatory government noises, such as Mr Putin's recent public instruction to the tax authorities to stop “terrorising” business, are automatically disregarded by Russian businessmen.

Will anyone be “next”? The Kremlin probably underestimated the economic impact of its grudge against the tycoons, and may now consider it has done enough *pour encourager les autres*. But, as capricious tax bills levied by freelancing officials have attested, the forces unleashed by the Yukos affair may be beyond Mr Putin's control. Whether oligarchs or smaller fry, businessmen sense that the old KGB adage—“Give us the man and we will find you the crime”—now characterises their dealings with the state.

The Trial

The charges in Mr Khodorkovsky's 11-month trial do not centre on the “loans-for-shares” rip-off that made him a multi-billionaire. They focus on the allegedly fraudulent part-privatisation in 1994 of Apatit, a fertiliser company, and of another firm, plus personal tax evasion, embezzlement of Apatit's profits

through a transfer-pricing scheme, and his leading of an “organised criminal group”.

Mr Khodorkovsky's defence has been that he was not personally responsible for the alleged crimes, or that the actions involved were not in fact illegal. He and his partners say that they turned Apatit from a failing company into a going concern, and that the problems over its acquisition have already been addressed in a civil suit. (Yukos's defence against the tax claims is essentially that “everyone was doing it”; indeed Sibneft, Mr Abramovich's firm, exploited the tax loopholes even more efficiently than did Yukos.)

But most people who visited the stuffy little room in the Meshchansky district courthouse, where the trial was held, emerged with the sense that the precise charges were beside the point. It was a bizarre scene: the accused's families and a clutch of journalists crammed on to a few benches, while Mr Khodorkovsky listened from the defendants' cage and, beside him, Mr Lebedev scornfully filled out Japanese crosswords. The three judges who came up with the verdicts—only a minority of Russian trials as yet involve juries—did not always seem to be concentrating.

This air of predestination was not unusual: almost all Russian criminal trials result in guilty verdicts. A report prepared for the parliamentary assembly of the Council of Europe last year catalogued the improprieties in the Yukos cases: restrictions on the defendants' access to their lawyers; capricious denial of bail; harassment of witnesses; and the unnecessary secrecy of the trial of Alexei Pichugin, a former Yukos security official sentenced to 20 years for murder in a trial that ended in March.

This is the second important lesson of the Khodorkovsky saga: that in Russia, power still matters more than the law. Property is held at the discretion of the president-cum-tsar. Invisible rules and relationships and grievances matter more than rules that are written down. (It is said in Moscow that when the Yukos bankruptcy case was dismissed by a court in Texas, which happened soon after the Russian and American presidents met in Slovakia, Mr Putin took it as proof that things worked just the same way in America.)

Perhaps this was Mr Khodorkovsky's biggest mistake: to think that Russia had changed more than it has. “We lived our lives in the Soviet period,” says his mother, “and we warned him that you cannot trust power in our country.” But, says Mrs Khodorkovsky, her son told her that the country had changed forever. Another view is that Mr Khodorkovsky came to believe that he was invincible, and that his real failing was a classic tragic flaw: hubris.

It is the government's behaviour, as much as Mr Khodorkovsky's own, that has made him an unlikely icon of dissent for Russia's band of put-upon liberals. “His case is a symbol of the authoritarian state, of the unclear rules of the game, of autocracy,” says Vladimir Ryzhkov, an independent Duma deputy. Russians revere suffering, and many have relatives who once spent time in prison on spurious grounds. In Russia, says Igor Shaitanov, a literature professor, “to be unfairly treated is a big step towards becoming a hero.”

It helps that Mr Khodorkovsky led a relatively unflamboyant life, buying no yachts or football clubs, and preferring camping holidays to orgies in the south of France. It also helps that he and his associates spent some of their money on good causes: an orphanage, a university (Mr Shaitanov's), think-tanks, and so on.

Reuters

Putin may have unleashed forces he can't

control

But the biggest contribution Mr Khodorkovsky has made to the transformation of his own image, in some quarters at least, from robber-baron to anti-authoritarian dissident, was simply that he stayed in Russia. Boris Berezovsky and Vladimir Gusinsky, two of the other original oligarchs who fell out with Mr Putin, gave up some of their assets and fled abroad, as have several of Mr Khodorkovsky's former associates. Mr Gusinsky left after a brief spell in prison persuaded him to cut a deal.

Mr Khodorkovsky, too, may have been supposed to crack and run. But, according to his mother, “To escape abroad means to admit one's guilt, and Misha does not accept any guilt.” Outside the court, as a few hundred supporters waved his portrait and yelled “Freedom”, Yevgeny Yasin, guru of Russia's liberal economists, said that by choosing to be a political prisoner rather than a political émigré, Mr Khodorkovsky had proved he was “a real man”. The Khodorkovsky fans were subsequently kept away from the court by riot police.

The last laugh?

Behind bars, Mr Khodorkovsky has also striven to re-engineer his reputation by issuing prison manifestos, which, like show trials, are a venerable Russian tradition. In the letters from his cell, Mr Khodorkovsky has criticised the inequities of the reforms that made him rich, assailed the liberal reformers for neglecting the plight of the common man, and abjured what he now calls “the tyranny of wealth”. In his last address to the Meshchansky court, he compared himself to the Decembrists, idealistic military officers who plotted unsuccessfully against the tsar in 1825.

The judges were still reading their verdicts as *The Economist* went to press, having repeatedly adjourned the hearing early. Though the final sentences had not yet been handed down, the judgment was said more or less to reiterate the prosecution's case (which called for ten-year jail terms). The two men will also face money-laundering charges, which will keep them in prison even if the sentences are light or suspended. Even a brief spell in a Russian jail, where tuberculosis is rife and “accidents” not uncommon, is perilous.

If he survives, what might Mr Khodorkovsky do? For all the mistakes and misfortunes of the last year—the Beslan calamity; the ill-conceived meddling in Ukraine; the botched introduction of social reforms—Mr Putin still enjoys strong public support, according to the polls, and he has nobbled the media to help him keep it. But his power-base in the elite, amounting to some *siloviki* and allies from his days in St Petersburg, is small. His enemies, meanwhile, are numerous. Mr Berezovsky and Mr Gusinsky, still rich men, have not given up hope of revenge. The other oligarchs have not generally spoken up for Mr Khodorkovsky, partly out of self-interest, partly because of old business grudges, partly because they worry that his obstinacy has jeopardised their own status. But none of them is fond of Mr Putin either.

He himself has denied rumours that he intends to change Russia's constitution and stand for a third presidential term in 2008. Many people are unpersuaded, and even he has not ruled out returning for another spell in the Kremlin in 2012, which the constitution would permit. By then, Mr Khodorkovsky—a ruthless man sunk by an even greater ruthlessness than his own—could be out of prison. The story of Putin and the oligarchs may not be over yet.

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The battle over the judges

Armageddon for the Senate

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From The Economist print edition

A momentous battle for both parties and the country has just begun

THIS week the Senate embarked on an epic struggle over the appointment of George Bush's nominees to the federal bench. The struggle will determine not only Mr Bush's ability to reshape the judiciary along more conservative lines, but also the balance of power in Washington, DC, between the Republicans and Democrats and, just possibly, the future of such controversial issues as abortion and the role of religion in public life.

The Senate has been struggling for weeks to avoid a showdown over filibusters—a parliamentary procedure for delaying votes which the Democrats have used to block Mr Bush's judges. To override a filibuster, the Republicans, who have 55 votes in the Senate, need 60 votes. They have threatened to invoke “the nuclear option” to change the rules that permit filibusters; to do this, they need just 50 votes (see article).

On May 16th, Bill Frist, the Republican majority leader, and Harry Reid, the minority leader, announced that they had broken off negotiations. A bipartisan group of senators, led by John McCain and Ben Nelson, desperately tried to broker a deal that would block any formal change in Senate rules while agreeing to have filibusters only in extraordinary circumstances. But as *The Economist* went to press, it looked as if any chances of a peaceful resolution were evaporating.

On May 18th, Mr Frist put forward the name of Priscilla Owen, a Texas state Supreme Court judge. Mr Frist is demanding that all of Mr Bush's nominees for the federal bench get an up-or-down vote. Anything short of that and he will move to bar the use of filibusters against judicial nominees. The Democrats have vowed to filibuster any unacceptable nominees. If they do so, Mr Frist will “go nuclear”.

The fight over Mr Bush's judges is the latest episode in the culture wars that have been tearing the country apart for decades. Since the 1960s the fault line in American politics has shifted from class to values. The issues that provoke the most passion are no longer who gets what but how people ought to live their lives.

Issues such as abortion and gay marriage make for ugly politics because there is little room for

compromise. The pressure groups on both sides believe in fighting to the death, sometimes literally. They have been greatly helped by campaign-finance reform (which has increased their fund-raising power relative to political parties) and technology (cable television and the internet have made it easier for single-issue generals to rally their troops).

The institution at the heart of the culture wars is not the Senate, but the Supreme Court. The court did as much as anybody to start the culture wars with a series of rulings—on school prayer, obscenity and, above all, abortion—that enraged conservatives. They are now determined to take back the judicial branch and overturn those controversial rulings. Liberals are equally determined to stop them.

The fight over the Supreme Court is at boiling point because one or more seats on the court could open up any time now. Two sitting justices, including Chief Justice William Rehnquist, who is suffering from cancer, are in their 80s; two more are in their 70s.

Liberal activists are united behind a strategy that might be dubbed “no more Clarence Thomases”. They are determined to prevent Mr Bush from appointing a female or minority conservative to one of the lower courts that traditionally serve as feeders to the Supreme Court. They fear that such a latter-day version of Clarence Thomas, the black justice who was appointed by Mr Bush's father, will split the Democratic coalition by appealing to conservative women or minorities.

The conservatives are equally determined to have as many Clarence Thomases up their sleeves as possible. That is why Ms Owen is the first judge being pushed forward. Following closely behind is Janice Rogers Brown, a sharecropper's daughter and the first black woman on the California Supreme Court, who won re-election by a colossal margin.

The stakes could hardly be higher for any of the parties involved in this dispute. If the Democrats lose their power to filibuster Supreme Court nominees, they lose control over the last branch of government where liberal America is reasonably powerful. The Democrats have threatened to retaliate by clogging up Senate business. That could backfire—as Newt Gingrich's Republicans discovered when they shut down the government in 1995.

More broadly, Democrats should be nervous about the filibuster debate for two other reasons. First, they may end up looking like obstructionists. Mr Bush, the “reformer with results”, and his party are already more identified with optimism. Second, the Democrats could end up looking like prisoners of coastal liberal interest groups. They desperately need to expand their geographical appeal: by the final weeks of last year's election, John Kerry had written off half the states.

The risks are even higher for the Republicans—and not just because, as the governing party, they are more likely to get the blame for any unpleasant fallout. To begin with, Mr Frist may not even have the 50 votes he needs. Three Republicans—Mr McCain, Lincoln Chafee and Olympia Snowe—have already signalled that they will vote against any rule change. Several others, including Susan Collins, Arlen Specter, Chuck Hagel and, possibly, John Warner, are wavering.

If they win, Republicans risk being depicted as extremists. The Terri Schiavo affair, where Congress intervened to try to save the life of a brain-damaged woman in Florida, was a public-relations disaster: it raised worries that ideological Republicans are willing to trample over constitutional checks and balances (such as states' rights). Ms Rogers Brown has argued that it is right to apply a “higher law” than the constitution. Such a blatant attack on the church-state divide worries even some conservatives.

The stakes are also high for the White House. In his first term, Mr Bush played a hardball version of politics, focused on rallying his base and picking off narrow groups of floating voters. This worked brilliantly as long as the Republicans were willing to march in lock-step behind him. But Mr Bush has had a notably tough time from his own party over his nomination of John Bolton for ambassador to the UN. If the filibuster is repulsed, Mr Bush's chances of ramming through Social Security reform will be weaker.

The battle goes deeper than the Senate; it could shape public opinion in the electoral cycle that ends in 2008. The Democrats have already won one round by dubbing filibuster-busting the “nuclear option”. (The Republicans prefer the “constitutional option”.) The job-approval ratings of congressional Republicans have fallen by four points since March to 35%, according to the Pew Research Centre. Mr Bush's rating is down to a miserable 43%.

But public opinion is still largely unformed. Only a third of the respondents to the Pew poll said that they were following the controversy about the filibuster closely. And those who did gave vaguely contradictory

answers.

Amid all this uncertainty, the filibuster debate has almost certainly harmed one institution: the Senate. It was deliberately designed by the Founding Fathers to be the deliberative branch of the American government. Senators, who sit for six years rather than the two years of the populist House, have long prided themselves on their independence. The politics of partisanship has now arrived in the upper chamber with a vengeance.

The Senate has long stood as a barrier to government activism on either side. In the 1960s, many liberals wanted to get rid of the filibuster to prevent a minority stopping their ambitious civil-rights agenda. Now it is conservatives who are upset about their frustrated hopes. The Republicans are not simply tampering with an arcane political device. They are weakening the ability of a future Republican minority to resist the steamroller of an activist liberal government. As the old saying goes, beware of what you wish for.

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The filibuster

How it works

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A guide to an irritating but vital tradition of the Senate

Easy come...
Confirmations, % of nominations*

Congress beginning	District President	Circuit Court	Court	Combined
1977	Carter	96.3	100	97.0
1979		90.5	89.8	90.4
1981	Reagan	97.2	95.0	96.7
1983		81.3	73.7	79.8
1985		95.0	100	96.2
1987		84.8	65.4	80.0
1989	Bush Snr	96.0	95.7	95.9
1991		69.9	64.5	68.9
1993	Clinton	90.8	86.4	90.1
1995		72.9	55.0	69.5
1997		84.2	66.7	80.0
1999		68.7	44.1	61.5
2001	Bush	84.7	42.5	72.5
2003		83.3	52.9	80.8

Source: Congressional Research Service
*Excludes renominations

IN THE 1960s, a handful of southern senators routinely managed to block civil-rights bills. They did this thanks to the filibuster, a Senate curiosity that allows a minority to slow down—or indeed kill—a law by refusing to close off debate. Filibustering senators have been known to recite recipes or read, for hours, from the telephone book.

The only way to stop a filibuster is to muster enough votes to “invoke cloture” and end debate. Today, the majority can shut off debate by getting 60 senators to vote for cloture; until 1975, the threshold was 67 votes. Thanks to the filibuster, the Senate does not operate by majority rule—though there are a few items, such as budget resolutions, that are safe from the device.

The Founding Fathers were mum on the filibuster. The constitution instructs both houses of Congress to adopt their own rules for proceedings; the Senate has chosen to operate by unanimous consent. This means that in principle, barring a cloture rule, a single senator could blather on, bringing the Senate to a halt. The Senate operated without a cloture rule from 1806 to 1917, when it was introduced at the urging of Woodrow Wilson, who was furious that a handful of senators were preventing him from arming American merchantmen against German submarines.

There is a difference between the more common legislative filibuster and the judicial filibuster at the heart of the current showdown. Legislative filibusters are used to force the majority to reshape laws. But a filibuster over a nominee is a zero-sum game: you cannot change the shape of a person. Also, with the legislative filibuster, the Senate is frustrating its own will; with a judicial one, the minority is interfering with two other branches of government, the executive and the judicial.

Before George Bush's election in 2000, only one judicial nominee had ever been successfully filibustered. Ten of Mr Bush's judges were filibustered in his first term. The judicial nominees of his father and Bill Clinton were blocked more often (see chart) but were thwarted by other tactics, such as keeping their nominations buried in committee.

Can the Senate change the rules on the filibuster? For 200 years, the chamber has operated on the understanding that any rule-change requires the vote of two-thirds of its members. The Republicans say this is not a fixed rule; so filibusters can be abolished on a simple majority vote. Others say that means rejecting a 200-year-old tradition of passing down rules and precedents from each Congress to its successor.

If the current debate does indeed “go nuclear”, Dick Cheney, who presides over the Senate, will issue a ruling from the chair to end filibusters of judicial nominees; when the Democrats object, the Republicans will vote down the objection with a simple majority. And then the fireworks will begin.

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Media scandals

A deadly blunder?

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Two paragraphs, many deaths, a *Newsweek* retraction

AP

America's conservatives are angry, too

IT HAS been a bad couple of years for the “liberal media”, with a stream of American news organisations, usually under fierce fire from conservative critics, having to admit errors in their reporting. None has had such serious consequences as the latest mistake, by *Newsweek,* which resulted in riots and deaths in the Muslim world.

Newsweek published a story in its May 9th edition, which appeared on May 1st, saying that the Pentagon would soon admit that officials at Guantánamo Bay had flushed a copy of the Koran down a lavatory. The story began to attract attention in the Muslim world on May 6th, when Imran Khan, a famous Pakistani cricketer turned politician, demanded that Pakistan seek an apology from America. Thousands of students in Jalalabad and Kabul in Afghanistan protested violently, and people demonstrated in Indonesia and Gaza. The worst scenes were in Afghanistan, where 17 people died and more than 100 were injured in protests.

At first the Defence Department neither confirmed nor denied *Newsweek*'s story; but it aggressively questioned it after the riots started. In its May 23rd issue, which appeared on May 15th, *Newsweek* issued a partial apology for the story. A day later, after bombardment from the Bush administration and others, it formally retracted it.

The biggest journalistic problem came because after publication and after the riots, *Newsweek*'s main source, according to the magazine, changed his mind about what he said he knew. According to its investigative reporter, Michael Isikoff, the source originally said that a forthcoming report from Southern Command in Miami, the military base that runs Guantánamo, would admit that someone in authority had put a copy of the Koran down a toilet to try to get prisoners to talk. When Mr Isikoff interviewed his source again later, the source told him that he could not be certain that he had read about the Koran incident in the report the magazine cited, and that it might have been in “other investigative documents or drafts”.

The White House spokesman, Scott McClellan, who called *Newsweek's* first apology insufficient, now

wants the magazine to go further and help “repair the damage” by “talking about the way they got this wrong”. He has suggested that *Newsweek* publish a story explaining the lengths to which the Pentagon has gone to meet the concerns of Muslim prisoners.

Conservative talk-shows and internet sites have depicted *Newsweek* as yet another liberal, unpatriotic media outlet only too willing to criticise America's conduct in the war on terror. The magazine's defenders argue that the fact that its source couldn't pinpoint the correct military investigative report does not mean that its story was wrong in substance. Testimony from prisoners at Guantánamo, after all, backs up the assertion that guards and interrogators have mistreated the Koran.

According to Shafiq Rasul, Asif Iqbal and Rhuhel Ahmed, three British inmates who were released last year, guards have indeed thrown the Koran in the toilet. Other current detainees have also complained about religious intimidation and humiliation at Guantánamo. Last week, according to both Reuters and Agence France Presse, Southern Command began an inquiry to check if its employees have ever thrown the Koran into the toilet.

That does not get *Newsweek* off the hook: after all, it published the story only because it believed the American army was actually admitting to abusing the Koran. Why did *Newsweek* rely on just one anonymous source?

The magazine, it turns out, thought the source was confirming other evidence. Its journalists (wrongly) believed that an account of flushing the Koran down the toilet was already contained in a series of internal e-mails released late last year from the FBI that described abuses at Guantánamo. In addition, Mr Isikoff's co-author, John Barry, showed a draft of the piece to an official at the Defence Department, who contradicted part of it, but did not quarrel with the part about the Koran. The journalists concluded that silence meant that the story must be right.

Other recent journalistic mistakes—at other venerable media outlets such as the *New York Times*, *USA Today*, CNN and CBS News—have resulted in people resigning or being fired, because internal rules were not followed. *Newsweek* is refusing to take any disciplinary action against its reporters, since it says the story was reported carefully. Its editors will also be aware that there is still a chance, however small, that Southern Command's inquiry, or another inquiry, will find that abuse of the Koran did indeed take place.

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About sponsorship

Base closures

Goodbye guns, hello golf

May 19th 2005 | LOS ANGELES
From The Economist print edition

Losing a military base may be a golden opportunity

“SOME have asked”, said Donald Rumsfeld this week, “why we are proposing any base closures during a time of war. The answer is because these changes are essential to helping us win this war.” And, of course, it makes financial sense. Closing 33 big bases and cutting back another 150 facilities should save the Pentagon close to $50 billion over the next two decades.

Correct or not, the defence secretary's reasoning is about to be attacked by state and local governments across the country. They have until early September to convince the independent Base Realignment and Closure Commission (BRAC) that their particular bits of America's vast military empire must be preserved from Rummy's axe. In the four previous BRAC rounds, the commission has approved 85% of the Defence Department's recommendations. In all likelihood, therefore, that means tough luck for politicians such as Senator Olympia Snowe of Maine, who describes the proposed closure of the Portsmouth naval shipyard, at a cost to the state of 4,510 jobs, as “nothing short of stunning, devastating and, above all, outrageous” (she has a point, since the navy secretary had just praised the shipyard for “a phenomenal record of cost, schedule, quality and safety performance”).

But, after the first shock, will BRAC decisions really be devastating? One good place to look is Irvine, in southern California's Orange County. Back in 1993, the closure of the El Toro marine corps air base was seen as a disaster. Now it is going to be turned into America's biggest park—bigger than New York's Central Park, San Francisco's Golden Gate Park and San Diego's Balboa Park combined. And it will not cost Irvine's taxpayers a penny.

In an auction in February, Florida's Lennar Communities paid $649.5m for the base. The navy will use the money for the environmental clean-up of El Toro and other bases; and Lennar will pay Irvine $200m in development fees and another $200m in property assessments. In return, Lennar gets the right to build houses and a golf course on 16% of the site.

Irvine's residents are not alone in their good fortune. Denver's Lowry air force base, a victim of the 1991 BRAC round with the loss of 2,275 jobs, is now a residential, office and park area providing 5,666 jobs; some of its 3,000 homes sell for more than $1m. The former Fitzsimmons army medical centre near Denver, a casualty of the 1995 round, is now on track to become a bioscience park providing more than 18,000 jobs within the next five years.

The problem, however, is that even though almost 85% of the 129,649 civilian jobs lost on military bases in the past four BRAC rounds have now been replaced with new ones (not counting jobs created off the bases), recovery is an uneven business. One reason is geography. If the Cannon air force base in a remote part of New Mexico closes because of the present BRAC round, it will be a lot harder for the civilian neighbours than the proposed loss of the naval surface warfare centre at Corona, which sits just east of the Los Angeles sprawl, or the naval weapons station at Concord in the Bay Area, where the land is so valuable that the locals petitioned to be put on the BRAC list.

But perhaps the biggest reason is that the various branches of the armed forces are messy tenants. They leave behind unexploded munitions, toxic waste and polluted groundwater, all of which must be cleaned up at military expense before being handed over for civilian use.

This is costly: some $11.9 billion so far, according to a study released in January by the Government Accountability Office. It is also time-consuming. At its McClellan base, one of the many Californian victims of the 1995 BRAC round, the air force in 2000 found traces of plutonium mixed in with radium-contaminated rags and brushes; the clean-up will not be finished until 2034. As Mr Rumsfeld observed

this week, “Change is never easy. In fact, Abraham Lincoln once compared reorganising the army to bailing out the Potomac river with a teaspoon.”

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The Supreme Court and free trade

In vino justitia

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If you liked the film “Sideways”, you'll love this ruling

“THIS is the best day for wine-lovers since the invention of the corkscrew”. That is the somewhat bubbly view of Clint Bolick, one of the successful lawyers in a ruling this week from the Supreme Court, which by a 5-4 majority freed up wine sales in New York and Michigan. But he has a point.

The court ruled that states which allow their residents to buy wine directly from in-state producers cannot stop them buying wine directly from sellers from other states. The decision is a victory for small vineyards, which currently struggle to compete with the “three-tier system” that dominates the market: big wine-makers sell to big wholesalers who then supply the retail outlets. According to Jeremy Benson, a wine-consultant in California, the top 50 of America's 3,500 wineries are responsible for 87% of the country's sales.

At the moment some 24 states—including Florida, Michigan and New York—ban direct shipments from out-of-state wineries. Another 13—including California, which produces $14 billion out of the $23 billion of American wine sold each year—have reciprocal agreements, allowing direct shipments only from states that accept direct shipments from them. A mere 13 states currently let the wine-connoisseur get on the phone or internet without restriction to order a subtle pinot noir from a small winery such as Lynmar Wines in California's Russian River Valley.

This absurd situation goes back to 1933 and the 21st amendment to the constitution, which ended Prohibition. The amendment gave power over the local liquor trade to the states. This week, the justices decided that it “did not give states the authority to pass non-uniform laws in order to discriminate against out-of-state goods, a privilege they never enjoyed.”

As Kathleen Sullivan, who argued one of the cases before the court, explained, the amendment involved a “classic clash” of constitutional principles: the guarantee of free trade under the commerce clause versus the guarantee of states' rights. The court did not split on political grounds: the four dissenters, for instance, included two conservative justices (William Rehnquist and Clarence Thomas) and two moderate justices (Sandra Day O'Connor and John Paul Stevens).

What happens next? In theory, state legislatures could now cite the decision to ban all direct sales. That would be the protectionist option—though it is also favoured by some people who are worried by under-age drinking. In practice, though, the states are likely to open up.

That is good news for Ms Sullivan's clients—two Michigan wine critics, Ray and Eleanor Heald, and Domaine Alfred, a California winery. The vineyard, which makes a mere 3,000 cases of wine a year, complained it could not satisfy orders from Michigan consumers because of the ban on direct sales; and going through a Michigan wholesaler would be too expensive because of the wholesaler's mark-up.

Around half of California's 1,300 wineries sell fewer than 5,000 cases a year. Other slightly bigger vineyards will also be able to expand. “We think it's a terrific deal,” argues Bill Murphy, owner of Clos LaChance, a winery just south of Silicon Valley which produces 30,000 cases a year and sells directly to some 20 states.

The wholesale industry is much less happy—not least because this week's judgment surely has implications for a case brought by Costco, the nation's largest wine-retailer, against the state liquor control board of its home state, Washington. At the moment, Costco cannot buy directly from out-of-state vineyards, but must go through Washington's three-tier distribution system, complete with mandatory mark-ups. Costco has argued that Washington's system flouts the Sherman Antitrust Act.

Now it can argue that it flouts the constitution, too.

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Oil for food

Gorgeous George takes the stand

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A virtuoso performance in Washington, but the show is not over yet

FEW recent episodes have illustrated the transatlantic divide more tellingly than George Galloway's performance before the Senate's Permanent Subcommittee on Investigations. The rogue British MP's assault on the committee and the Bush administration pushed him to the top of the news in Britain, with even conservative publications admiring his nerve. In America, such liberal bastions as the *New York Times* banished him to the inside pages; and he got only a quick mention on the network newscasts.

In terms of entertainment value, this was America's loss. The altercation between the rambunctious Scottish representative for Bethnal Green and Bow and Norm Coleman, the committee's increasingly bewildered Republican chairman (or the "lickspittle of George Bush" as the MP sees him) was parliamentary theatre of the sort Congress too rarely witnesses.

The committee had accused Mr Galloway of getting lucrative oil allocations doled out under the UN's oil-for-food programme in Iraq. Mr Galloway denied getting any oil, and took Mr Coleman to task for sullying his name without ever talking to him: "Now, I know that standards have slipped over the last few years in Washington, but for a lawyer, you're remarkably cavalier with any idea of justice."

Repeatedly, Mr Galloway gave the impression that Mr Coleman was the one who was really under investigation. He denounced the oil-for-food inquiry "as the mother of all smokescreens" designed to distract people from the illegality of the Iraq war. When asked how many times he had met Saddam Hussein, he said twice—the same number of times as America's defence secretary. "The difference is, Donald Rumsfeld met him to sell him guns...I met him to try and bring about an end to sanctions, suffering and war."

Yet it was hardly the knock-out victory that Gorgeous George (as he is known in the Labour Party) was awarded in Britain. Mr Galloway's blustering was under oath, and the committee claims to have several documents from the Iraqi oil ministry naming Mr Galloway and the Mariam Appeal, a charity that he set up to help a sick Iraqi girl. Mr Galloway called the documents forgeries; but he repeatedly deflected questions about Fawaz Zureiqat, the Jordanian head of the Mariam Appeal.

And in one respect, Mr Galloway is indeed a side-show: he represents a party of one in the British Parliament. A far more serious development this week was the release by Mr Coleman's committee of a report that accused many Russian politicians, including some in Vladimir Putin's inner circle, of making huge profits by illicitly dealing in heavily discounted Iraqi oil allocations.

In one way, this was not new: the Iraq Survey Group accused Iraq of attempting to influence Vladimir Putin's advisers "on a lavish and almost indiscriminate scale". But Mr Coleman's committee names the alleged beneficiaries—and connects the gifts to Russian foreign policy. For instance, it claims to have evidence that Mr Hussein once instructed his officials to "show gratitude" to Russia for threatening to use its veto to thwart an American-British plan for tough sanctions in 2000. That could yet be the true Mother of all Smokescreens.

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Terror in Florida

A tale of two suspects

May 19th 2005 | MIAMI AND TAMPA
From The Economist print edition

If you are going to kill innocent foreigners, best to do it in Cuba not Israel

IT IS hard to find a better symbol of the Palestinians' generally disastrous attempts to present their case in America than Sami al-Arian. The Kuwaiti-born professor at the University of South Florida set up the World Islam and Studies Enterprise (WISE), a pro-Palestinian think-tank, in 1990. As a pleader for the Palestinian cause, he subsequently met both President Bill Clinton and (then) Governor George Bush; after the September 11th attacks, he had a famous shouting-match about the Middle East on Fox News with Bill O' Reilly, a staunch conservative defender of Israel. This week, jury selection began in a trial in which Mr Arian stands accused of financing terrorism.

The government alleges that Mr Arian and six other defendants used WISE to funnel cash to Palestinian Islamic Jihad. The money was then used to finance attacks which have killed more than 100 Israelis and two Americans. Mr Arian also faces money-laundering and racketeering charges.

Interestingly, the case began in 1994 when a PBS documentary, “Jihad in America”, focused on a number of WISE conferences at the University of South Florida organised by Mr Arian and Mazen al-Najjar, his brother-in-law, who was also a professor in Tampa. A year later, the university stopped sponsoring WISE conferences. Mr Najjar was arrested in 1997 on visa charges and deported. Mr Arian was arrested in 2003.

As he was led into Tampa's FBI office, Mr Arian insisted the case was “all about politics”. More than 100 Israelis are expected to testify at his trial, mostly for the prosecution. His lawyers maintain that he will never get a fair trial in Tampa, where his alleged sins have been remorselessly examined in the local press. In an attempt to switch the venue, they have presented the federal judge who is overseeing the case with a poll showing that 55% of people in Tampa believe that Mr Arian is guilty, while only 33% do in Atlanta.

The start of Mr Arian's trial has now been delayed until June while the judge considers the change-of-venue motion. But America's definition of terrorism may be also being tested in another case in Florida—that of Luis Posada Carriles.

While Mr Arian denies any involvement in terrorism, Mr Posada is a self-styled freedom fighter, who has been plotting violent attacks on the regime of Fidel Castro for 45 years. He is also wanted in Venezuela as a prime suspect in the bombing of a Cuban airliner in 1976 in which 73 people died (he has adamantly denied any responsibility). This week, the CIA-trained Cuban was arrested for entering the country illegally. It is unclear what the Bush administration will do with him. But, politics apart, what exactly is the difference between Mr Posada and Mr Arian?

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Lexington

On the border

May 19th 2005
From The Economist print edition

The best solution so far to one of America's thorniest problems

Get article background

THERE are many reasons for moderate pragmatists to be irritated by the culture wars that are consuming American politics. They are polarising an already polarised electorate; they are reigniting the politics of personal destruction; and they are filling the airwaves with mind-numbing debates about filibusters. But the biggest reason is that they are diverting attention from other pressing problems.

Immigration is a good example. There is no doubt that America's system is badly broken, with, perhaps, 10m immigrants working in the country illegally and another 1m arriving every year; there is equally no doubt that this imposes huge costs on the country in terms of lawlessness and human misery. On May 12th, two powerful senators, Ted Kennedy and John McCain, proposed a sensible solution. Yet their arguments risk being lost in the babble about John Bolton and judges.

America's present immigration law flies in the face of economic reality. The economy is creating far more low-end jobs than American workers are willing to take (the proportion of native-born Americans dropping out of high school has fallen from half in 1960 to just 10% today). Entire industries—agriculture, food-processing, construction—rely on cheap immigrant labour. But America's yearly quotas are far too small to satisfy its needs.

The resulting black economy undermines the rule of law. Check into a hotel, and you may be the beneficiary of a complex chain of law breaking. The hotel owner may have hired illegal immigrants. The valet-parker may have paid $2,000 to be smuggled across the border by a criminal gang. Several of his friends may have died trying to get in (last year 200 immigrants, including a three-year-old child, died in the Arizona desert). The criminal gang may have engaged in shoot-outs with immigration officials or rival gangs. His $2,000 fee may have been used to subsidise drug-smuggling. Tamar Jacoby, a Manhattan Institute scholar who is a beacon of light in a foggy debate, likens the current immigration laws to prohibition: impossible to enforce, they encourage a whole sub-culture of criminality.

The black economy also threatens two things pretty much all Americans hold dear. The first is the cherished tradition of assimilation. Illegal immigrants live in a shadow world where they are reluctant to

put down roots and even visit their children's schools. The other is national security. The easiest way for a terrorist to enter the country without a trace is through Arizona. Forget about visas and background checks. All you need to do is hire a *coyote*: he will smuggle you across the border, no questions asked, and then plug you into a criminal network that specialises in giving people false identities and hiding them in a huge illegal sub-culture.

The Kennedy-McCain bill is the result of ten months of hard slog. The two senators were still hammering out the details the day before they unveiled their plan. But the product is a hard-nosed law that tries to align America's immigration laws to the economic realities without rewarding illegal behaviour.

The bill provides both illegal workers and law-breaking employers with a ladder out of the shadow world they now inhabit. Illegal workers will be allowed to apply for temporary work permits (which will not be tied to specific jobs, as in earlier schemes). And employers will be allowed to hire immigrant workers if they can demonstrate that no Americans want their jobs. But at the same time the bill avoids being soft on illegal immigration. Any illegal immigrants in the country will pay hefty fines, as well as their back taxes, and go to the back of the queue for green cards. Employers will also face much stricter penalties. Money will be pumped into border security and a new system of tamper-proof identity cards.

Jumping over the congressional barrier

Plenty of people on both sides of the spectrum want to stop this bill. The AFL-CIO union combine has declined to endorse it. A mainly Republican anti-immigration caucus in the House contains around 70 diehards united behind the idea “What part of illegal don't you understand?”; they have just demonstrated their legislative muscle by pushing through a bill that makes it harder for illegals to get driving licences. John Cornyn, the chairman of the Senate sub-committee on immigration, has made it clear that he's opposed to any bill with a “work and stay” provision. Meanwhile, the White House, which has been badly burned on Social Security reform, is reluctant to spend significant amounts of political capital on an issue that so divides Republicans.

Yet immigration reformers also have muscle on their side. Employers' groups and some unions are behind the bill. So are many border-state politicians who know the status quo means chaos. And there is the clout of the two sponsors. Mr Kennedy remains the most determined legislative warhorse in the Senate. Mr McCain is a charismatic reformer with a broad constituency (particularly in the media). Both men are past masters at pushing complicated bipartisan legislation through Congress, including far-reaching reforms of education and campaign finance. They have already recruited Joe Lieberman and Sam Brownback.

The reformers' most important ally, though, is common sense. America has spent millions of dollars trying to tighten up its borders only to see the situation get worse. It now relies on illegal workers to pick its vegetables and build its buildings. Closing the border is impossible without some sort of legalisation for the millions in the country; mass deportation would do irreparable harm both to America's economy and to its traditions as an immigrant-friendly nation.

The problem for Messrs Kennedy and McCain is that common sense needs the oxygen of publicity if it is to breathe. And for the moment all that oxygen is being consumed by tedious debates about the virtues of filibusters.

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Brazil's landless movement

A thin red line

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From The Economist print edition

AFP

Land reform makes sense, but its loudest advocates often do not

THEY had been marching for two weeks, red-flag-waving protesters forming a procession two miles long, and on May 16th they swarmed into Brasília, Brazil's capital, to press their demands on the government: reversal of its tough economic policies, “rescue” of Brazilian culture and, above all, redistribution of land.

This was the big set-piece of the Movement of Landless Rural Workers (MST), the noisiest representative of Brazil's 4m landless rural families. No political force in Brazil is more divisive. To sympathisers, the MST represents a thrilling act of self-assertion by the normally quiescent poor. (Noam Chomsky, an American leftist, deems it “the most important and exciting popular movement in the world”.) To foes, it is utopian, lawless and dangerous to Brazil's economy.

The MST helped elect Brazil's left-leaning president, Luiz Inácio Lula da Silva, in 2002, but has been an irritant to him ever since. Lula had promised to ramp up land reform by distributing to poor families “unproductive” land expropriated by the state and other federal property. Hamstrung by tight budgets, he has so far failed to deliver. His government has settled an average of 59,000 families a year (fewer, claims the MST), compared with 66,000 under the previous administration.

The protests threaten Brazil's investment climate more than they do the government. Across Brazil, property deemed unproductive by the MST is subject to invasion by landless groups hundreds strong. Unproductive is defined loosely: a eucalyptus forest in São Paulo state that feeds a paper factory owned by Votorantim, a conglomerate, has been invaded three times this year.

Sometimes families occupy private property close to the intended homestead to force the government to award title. Police have not dealt as firmly with this as property owners would like. By sympathising with the MST, Lula often finds himself accused of undermining property rights, and thus Brazil's competitiveness.

The protesters' opponents can behave even worse. More than 1,000 rural activists have been murdered, many of them from the 20-year-old MST; last year, 39 people died in Brazil's land wars, according to the church-linked Comissão Pastoral da Terra.

The MST has some odd ideas. “We have to stop this business of producing for export,” says Vicente Almeida, an MST official, toppling in his imagination a pillar of Brazil's economy. But its basic point is sound: Brazil's land ownership is one of the most unequal in the world, with just 1% of Brazilians owning half of all fertile land. Rural poverty is a blight and part of the cure is land reform.

Family farms, whatever their size, are more productive than those worked by hired labour. How should the land be distributed? Handing it out to poorly educated labourers, many of them escaping dead-end lives in cities, is not a sure-fire recipe for prosperity. The press regularly carries stories of abandoned plots and unrelieved misery on settlements established by the government.

Rates of failure vary, however, and the overall record is not that bleak. As Gerd Sparovek of the University of São Paulo's agricultural school, points out, at least settlers no longer have to leave their families to chase seasonal employment and most do manage to feed themselves, which is an improvement over their landless state. He reckons that little more than a tenth of settlers abandon their plots.

The World Bank backs another model entailing negotiated sales of land to groups of farmers financed by government grants and loans. One pilot study suggests that such projects have raised farmers' incomes by 75% since 1999. The MST complains that this “market-based model” saddles farmers with unmanageable debts and poor land. But the World Bank says that 85% of borrowers are paying on time. The government persists with the programme, but quietly.

Bring on the revolution

As expected, Lula paid court to the 15,000 activists camped on his doorstep this week, promising extra funds for land redistribution, the settlement of 430,000 families by the end of his term next year and an even looser official definition of what constitutes unproductive land. If he fails again, he can expect “a much bigger demonstration”, says Jacinto Jomualdo, an MST activist from São Paulo state. But the landless do not really blame their former comrade for the slow pace of progress. What Brazil really needs, says Mr Jomualdo, is “a social revolution.”

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Canada

Belinda's leap

May 19th 2005 | OTTAWA
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Will an eleventh-hour defection save the Liberals?

AP

Mr Martin's saviour?

Get article background

FOR the most part, as befits a seriously grown-up country, Canadian politics proceeds at a stately pace. Lately, however, the parliamentary scene in Ottawa has become so exuberant that it is hard for a stately weekly such as *The Economist* to keep up. As we went to press on May 19th, Paul Martin's Liberal government faced the possibility of defeat on a spending bill, and hence yet another general election just a year since the last one, at which Mr Martin lost the handsome majority he had inherited from the former Liberal leader, Jean Chrétien, and formed an embattled minority government.

Mr Martin, who laboured solidly as finance minister when Mr Chrétien had the top job, has had pretty rotten luck as prime minister. His fortunes took a spectacular turn for the worse when Canadians learnt that Mr Chrétien had bequeathed him not just the leadership but also a scandal, in which the previous Liberal government is alleged to have misused a C$250m ($200m) scheme to promote the federal cause in the French-speaking and intermittently separatist province of Quebec.

This scandal, now being investigated by a judge, John Gomery, has given the opposition Conservatives and Quebec separatists a scent of blood and set the scene for their bid to fell the government in Thursday's budget debate.

Two days before the vote, however, Mr Martin enjoyed a rare stroke of better luck when he managed to coax a prominent Conservative member of parliament, Belinda Stronach, across the floor to join the Liberal cabinet as human-resources minister. This was not only a blow to the morale of the Tories—she took care as she defected to denounce their leader, Stephen Harper, for joining with the separatist Bloc Québécois in attacking the budget and so threatening Canada's unity—but a possibly decisive twist in the parliamentary arithmetic as the big vote approached.

Still, Mr Martin will not be home free even if his government does survive the week. He has promised an election within 30 days of the release of Judge Gomery's report, due in December.

And Mr Harper may secretly welcome having to wait till then. The latest polls (taken before Ms Stronach's leap) showed the Tories stalled at 32% and the Liberals leading by eight points in the crucial

battleground of Ontario. Ms Stronach was not only Mr Harper's chief rival for the party leadership last year but also the Conservatives' strongest asset among younger voters in Ontario.

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Elections in British Columbia

A rebuff for Mr Campbell

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From The Economist print edition

The province's ruling Liberals suffer a drubbing at the polls

FOUR years ago, it looked as if British Columbia's notoriously polarised politics had swung decisively to the right. Trashing a despised leftish New Democratic Party (NDP) government, voters gave the Liberal Party (quite a different animal from Canada's eponymous ruling party) an unprecedented 77 out of 79 seats. This week, the pendulum swung back. In elections on May 17th, the Liberals suffered near defeat, seeing their number of seats slashed to 47 and their majority to seven, while the NDP grabbed a remarkable 32 seats.

Gordon Campbell, the province's premier, cannot be surprised. Dour, uncharismatic and unpopular, he angered many with his apparent indifference to the impact of corporate downsizing. Not even his deep cuts in personal income tax (25%) and corporate tax (20%) were universally appreciated. High-earners and business leaders welcomed the cuts, but others decried them for creating a new deficit, only wiped out after a harsh programme of welfare cuts, hospital and school closures, and the privatisation of hospital support services and BC Rail.

Running on a slogan of “Our plan is working”, Mr Campbell clearly expected that balancing the books and presiding over renewed prosperity would pay off. BC now has its lowest jobless rate in 25 years and Canada's fastest-growing economy. But economists attribute this as much to rising commodity prices and demand for BC's lumber, oil, gas and coal exports as to the Liberals' business-friendly policies.

The NDP's untried new leader, Carole James, a feisty former child-care worker, struck a chord with voters with her campaign to “end one-sided government that benefits only a few”, winning 41% of the vote to the Liberals' 46%. A further 9% backed the Green Party, which missed winning its first seat.

Ms James's moderate style and message (no tax increases, an end to privatisation, more spending on health and education) appealed to many British Columbians. But business leaders are worried about her vague plan—help for diversification, tax incentives for innovation—to keep the economy growing. Mr Campbell's C$10 billion ($8 billion) transportation-expansion plan, aimed at boosting exports to Asia, is more enticing. If followed through, it could lead to a rare third term in office.

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Chile

Reshuffling the electoral cards

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From The Economist print edition

A surprise presidential candidate may signal a new era in Chilean politics

Get article background

UNTIL last week, Chile's opposition parties were pretty much resigned to losing the next presidential election, due in December, and seeing the centre-left government coalition take a fourth term in office. But now, following a rebellion in the National Renewal (RN), the smaller of the two main opposition parties, the race has been thrown wide open.

Divisions within the opposition alliance—an uneasy marriage between the RN and the more right-wing Independent Democratic Union (UDI)—are nothing new. The RN has long been angered by the perceived steamrolling tactics of its more disciplined and dogmatic ally. It is also frustrated by the lacklustre performance of Joaquín Lavín, hitherto the opposition's presumed joint presidential candidate, who almost defeated President Ricardo Lagos in 2000, but has since lost much of his popular appeal.

The RN nevertheless surprised everyone when, at a meeting on May 14th called to endorse the UDI's Mr Lavín, it voted overwhelmingly to proclaim one of its own former leaders, Sebastián Piñera, as its presidential nominee.

A successful businessman worth an estimated $1.3 billion, Mr Piñera has the advantage of being able to finance his own campaign. His opposition to General Augusto Pinochet in the late 1980s also makes him more acceptable to centrist voters, whereas the UDI remains tainted by its association with the former dictator.

Could Mr Piñera win? His aides predict that in the first round of voting he will come second to Michelle Bachelet, the main government contender, forcing a run-off which he could win by picking up Mr Lavín's votes and those of centrist voters nervous about Ms Bachelet's socialism. But could he rival her charisma?

Whatever the outcome, Mr Piñera's candidacy signals a welcome end to the division of Chile's political parties along the fault line of those who opposed or supported the Pinochet dictatorship.

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Gays in Mexico

Out and proud

May 19th 2005 | MEXICO CITY
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Vanquishing homophobia

Reuters

The closet is for clothes

FROM trendy minimalist cafés catering to a new generation of the out and the proud, to porn movies with actors dressed as traditional masked wrestlers, small businesses aimed at Mexico's gays are suddenly popping up everywhere.

This is most noticeable in the capital's Zona Rosa, or Pink Zone, an accidentally appropriate name for an area that has become a magnet for young gays, who wander around hand in hand without an apparent thought for Mexico's legendary homophobia. Once home to a bohemian artistic vanguard, the area had fallen on seedier times, becoming awash with table-dance clubs and furtive gay prostitution. Then came the pink revolution.

A year ago, Mexico's first unashamedly gay café opened in the Zona Rosa. Bgay Bproud's large windows look out boldly onto the street, offering both a real and a symbolic invitation to passers-by to look in on a newly confident community. Now there are three other openly gay coffee-shops in the same street. The area is also home to an impressive range of gay clubs, bars and restaurants, from the sex-driven to the status-conscious, as well as an array of travel agents, bookshops and even a lawyer's office, all specialising in services for gay people.

In all, Mexico City's metropolitan area is reckoned to have more than 100 gay businesses. Although there is no obvious single trigger for the boom, it is clearly linked to the rise of a new cable-TV generation that has grown up on programmes such as “Will & Grace” and “Queer as Folk”, unwilling to skulk in the shadows or behind blacked-out windows.

Bigger firms are now beginning to weigh the potential of Mexico's unexploited pink peso. A market-research study last year found that gays in Mexico have a lot more ready cash than their child-burdened heterosexual peers. Mexican lesbians, for example, spend 60% more on beauty products than the average adult female, and are six times more likely to have access to the internet.

Four years ago, a national survey showed that two out of three Mexicans opposed living under the same roof as a homosexual. But acceptance is growing. Last month, the nominally right-wing federal government released two radio spots directly challenging homophobic attitudes. They provoked

predictable protests by pro-life groups, but were generally well-received by the man in the street.

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Growing protests in Bolivia

Mocking Pilate

May 19th 2005 | BRASÍLIA
From The Economist print edition

President Mesa washes his hands, but may not save his head

Get article background

CARLOS MESA faced a bleak choice: to risk his job by vetoing a law that sharply raises taxes on foreign energy companies, thereby provoking street protests that could topple his government; or to risk irrelevance by letting the law stand, even though he deems it a threat to the country's unity. Bolivia's president chose the latter course. On May 17th the head of the Senate signed into law a measure that Mr Mesa had refused to approve or veto. Ironically, this evasive manoeuvre may not forestall protests or keep him in office.

The law slaps a 32% production tax on top of royalties of 18% paid by producers of natural gas and oil, which have invested $3.5 billion in Bolivia since the mid-1990s. It also obliges them to turn over possession of the pumped gas to the state-owned energy company, YPFB. There is no chance now of new investment in projects such as a pipeline to boost exports to Argentina, says Carlos Alberto López, an energy consultant. The eastern provinces of Santa Cruz and Tarija, where the energy industry is based, are demanding autonomy and popular election of provincial governors.

Yet the law is not tough enough to satisfy radical social movements, some of which are now demanding complete nationalisation of the gas industry. Thousands demonstrated in cities on May 16th and some roads to La Paz, the capital, were blockaded.

In the short-term, Mr Mesa's survival probably depends on the intensity of these protests. He came to office in 2003 after 60 demonstrators were killed in clashes with the army, forcing the resignation of the previous president. As a result, Mr Mesa refuses to use force against protestors, even when they blockade roads.

Even if tempers cool, it is hard to see how Mr Mesa, now mocked as “Pilate” for dodging responsibility for the energy law, can restore his authority. The main political forces spurned his invitation to discuss a possible compromise on the energy law and on such burning issues as a new constitution and provincial autonomy.

The head of the army worries that Bolivia could be “on the way to disintegration”. Mr Mesa threatened to resign twice in March and may soon renew the offer. The presidency could then pass to the Senate's president, Hormando Vaca Diez, who clearly wants it, or new elections could be held. But it may be that no president can win a mandate to govern Bolivia.

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Uzbekistan

The blood-red revolution

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EPA

Islam Karimov has lashed out at peaceful demonstrators, and by doing so has perhaps brought his own downfall closer

WILL Uzbekistan be the next former Soviet republic to be swept up in revolution? Following the rose revolution in Georgia, the orange revolution in Ukraine, and the tulip revolution in Kirgizstan over the past 18 months, it seems more than possible. But if so, it may be called the red revolution, because of the government's slaughter of perhaps several hundred—the exact number is still unknown—peaceful demonstrators in the Ferghana valley last week.

Uzbekistan officials now acknowledge 169 dead, while the opposition Ozod Dehqonlar (Free Peasants) party sets the toll at 745, and some speak of thousands. The violence was set off by a trial in the eastern Uzbek city of Andijan of 23 businessmen charged with being Islamic radicals and members of Akramiya, an offshoot of the outlawed extremist organisation Hizb-ut-Tahrir, which they all deny. Hizb-ut-Tahrir is accused of terror attacks in Uzbekistan last year that killed more than 50 people. On May 12th, a large group of the defendants' supporters attacked a police station and a military garrison, seized weapons, and stormed the prison, freeing the accused and all other inmates. They then went on to capture the regional government building and tried to seize the local office of the National Security Service, but were driven back.

The versions of who was behind this assault and what happened next differ significantly. Uzbekistan's President Islam Karimov claims the defendants' supporters were Islamic extremists, inspired by the overthrow of the government in neighbouring Kirgizstan in March, who wanted to reproduce the event and to set up a caliphate. But the men on trial are considered by many to be pious, reputable businessmen who have provided employment to people in the poverty-stricken Ferghana valley and, according to their advocates, were imprisoned on trumped-up charges.

After the takeover of the government building, a crowd of up to 20,000 people gathered in the central square of Andijan on May 13th, where they stood all day. “They didn't want a caliphate, they wanted bread and democracy,” says Bahadir Namazov of Ozod Dehqonlar. Towards the evening, troops moved in and opened fire, shooting indiscriminately at unarmed demonstrators, striking numerous women and children. According to reports, many were shot in the back of the head.

At first, the Uzbek leadership admitted only that ten government soldiers and “many more” rebels had been killed. But following international pressure, the authorities conceded on May 17th—a day before a visit to Andijan organised for foreign ambassadors—that 169 were killed, including 32 troops and 137 “terrorists”. Meanwhile, Ozod Dehqonlar maintains that apart from 542 dead in Andijan, 203 more people were killed by troops in Pakhtabad, another city in the Ferghana valley, when they were trying to flee to safety across the Uzbek-Kirgiz border.

The situation in Uzbekistan remains very tense. Oddly, the shooting of the protesters in Andijan seems to have reduced, rather than increased, people's fear of the government's harsh reprisals against any form of dissent. Until May 13th, anger and frustration over the lack of reforms, jobs and freedom of expression were kept in check by the knowledge of Uzbekistan's abominable human-rights abuses and the existence of 6,000 religious and political prisoners. But over the weekend, the people of Korasuv, a town on the Uzbek-Kirgiz border, went on a rampage, beating up the mayor, torching cars and rebuilding a bridge link to Kirgizstan which had been destroyed two years ago by the authorities to prevent imports. On May 19th, government forces retook the town, apparently without bloodshed.

Will the uprising spread? It is not yet clear whether the news about the bloody clashes in Andijan and elsewhere has even reached all parts of the country. Uzbekistan's state media ignored the carnage and broadcast classical-music concerts, wildlife features and cartoons instead. International news channels and websites were blocked. “The question is whether people now think they have nothing left to lose or not,” says one western diplomat.

Mr Karimov's survival will depend, in part, on the attitude of the outside world. So far, America's condemnation has been slow and limited, while Russia has made it clear that it supports him in his battles against Islamic “terrorists”. The massacre may represent an opportunity for the Kremlin. Mr Karimov has divided his loyalties between Moscow and Washington, annoying the Russians by cultivating the Americans after September 11th, though he has since swung back a bit. After Andijan, he may oscillate further towards Russia. Something similar happened in both Ukraine and Kirgizstan, where Leonid Kuchma and Askar Akaev turned to Moscow when the going got tough.

In neither case, of course, did that preserve their regimes. Alexei Malashenko, an expert on Central Asia at the Carnegie Moscow Centre, argues that unless it wants to repeat the mistake it made in neighbouring Tajikistan—whose Islamists the Russians criticised, only to see some of them wind up in government—the Kremlin needs to think about the sort of regime that is likely to follow Mr Karimov's, whenever that may be.

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South Korea

The daughter also rises

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The next South Korean president might be a woman

Get article background

BIRTH still matters in South Korea—at least so far as the leader of the main opposition Grand National Party is concerned. But Park Geun-hye, whose chances of becoming Korea's first female president have been boosted by her party's recent success at the polls, seems to be liked and loathed in equal measure because of it.

Ms Park is the daughter of South Korea's former military dictator, Park Chung-hee, who ruled the country during the 1960s and 1970s, delivering an economic miracle but trampling on human rights. Ms Park's introduction to public life came early. She took over as first lady after her mother was shot dead in 1974 in a botched attempt on the life of the president. Five years later, he was killed by his own intelligence chief.

Amid changing times and economic uncertainty, Ms Park has inherited some of the respect accorded to her father. Her parentage has helped her overcome the disadvantage of her sex in a strongly patriarchal society. But she is also criticised as a political lightweight. To many younger voters she smacks of a bygone era; a woman whose only qualification is to have been her father's daughter.

Within the Grand National Party, however, worries about her have fallen away since the by-elections of last month. Under her leadership, the party swept up five of six available seats and prevented the ruling Uri party from regaining its parliamentary majority. She has clearly boosted her chances of winning her party's nomination for the presidential election in 2007.

Ms Park refuses to admit to presidential aspirations, but describes the election victories as her party's starting point for the next presidential campaign. She accuses the government of ignoring bread-and-butter issues, and instead being overly obsessed with controversial measures, such as a bill repealing an anti-communist national security law.

Supporters say that her strengths include a commitment to the alliance with America, making her well-placed to mend South Korea's strained ties with its closest friend. Her attitude to North Korea is pragmatic. Although she talks tough, she paid a visit to the North Korean leader, Kim Jong-Il, three years ago and shook his hand, despite knowing that it was he who instigated assassination attempts on her father's life.

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Taiwan and China

Muted celebration

May 19th 2005 | TAIPEI
From The Economist print edition

President Chen downplays talk of better ties with China—but there is hope of making the status quo more durable

Get article background

Reuters

Chen the wary

THE visits to China by the leaders of Taiwan's two biggest opposition parties in late April and early May have been hailed in China, and more guardedly by America, as a welcome easing of tensions across the Taiwan strait. One man, though, takes a much more cautious view. He is Taiwan's president, Chen Shui-bian.

"[The Chinese] want to split Taiwan, incite Taiwan and create divisions in Taiwan in order to achieve their political aim of isolating the Taiwan government, including President Ah-bian," says Mr Chen, referring to himself by his nickname. He accuses Lien Chan of the Nationalist Party or Kuomintang (KMT) and James Soong of the far smaller People First Party (PFP) of being "very naïve" in their expectations of China's willingness to compromise, and criticises them for allegedly failing to stress Taiwan's sovereignty during their trips.

Mr Chen is clearly relieved by his party's performance in elections last weekend to an ad-hoc assembly that is being convened in order to pass constitutional amendments. With both the KMT and Mr Chen's Democratic Progressive Party (DPP) supporting the amendments—which will halve the number of legislators and simplify the way they are elected—few saw much need to brave the rain. But of those who did, more voted for the DPP or its even more China-sceptic ally, the Taiwan Solidarity Union, than for the KMT or the PFP, which favour conciliation.

In an interview with *The Economist*, Mr Chen said on May 17th that the results showed that what he calls the recent "China fever" in Taiwan is on the wane. China's refusal yet again to allow Taiwan into the World Health Organisation during a meeting of its governing assembly in Geneva this week has made people "clearer" after a period in which many had "illusions" about China.

Mr Chen's downbeat appraisal of cross-strait relations is not surprising. He has been attacked by his own camp for having switched from initial hostility to the opposition-party visits to tentative endorsement (only, many believe, because America, Taiwan's only military backer, made clear its support). The visits evinced much goodwill rhetoric from China, but no clear commitment to engage directly with Mr Chen's government.

But 56 years into their stand-off, and six years after China suspended cross-strait dialogue in pique over Taiwan's insistence that it was just as much a country as China, there are signs that both sides are trying to find ways of talking again.

The most difficult issue is how to circumvent China's insistence that Taiwan accept the principle that there is only one China, of which Taiwan is a province. Before Mr Chen took office in 2000, it was possible for Taiwan to finesse this by accepting the idea of one China, but explaining this in terms of Taiwan's constitution, which suggests the island is part of a Republic of China, just not the communist People's Republic of China. Mr Chen, however, has refused to support the "one China" notion, seeing it as undermining the sovereignty he believes is enjoyed by the island of Taiwan itself.

A consensus reached last week between China's President Hu Jintao and the PFP's Mr Soong coined a new term, “two sides [of the strait], one China” as a basis for talks. This appeared to be an attempt to suggest equality between Taiwan and the mainland. However, Mr Chen's initial reaction is not encouraging. The term, says the former lawyer, is a “step backwards” because it does not actually suggest that any differing interpretations of “one China” are allowed.

But Mr Chen himself shrinks from using terms that have riled China in the past, such as “one state on each side” or “state-to-state relations [between Taiwan and China]”. It is better, he says, “to speak less about sovereignty”. He, like the opposition leaders, calls for maintenance of an undefined status quo. China too appeared to shift in this direction, saying in its agreement with Mr Soong that war could be avoided as long as there was no chance of a move by Taiwan toward formal independence. In other words, it seemed to imply, the status quo would be tolerable. In the past, China has threatened war against Taiwan simply for refusing to talk.

After the failure of the DPP and its allies to gain a majority in a parliamentary election last December, China has even less reason to worry about Mr Chen using his remaining three years in office to affirm the island's independence through changes to the constitution. The revisions likely to be adopted in the next few weeks will require any further constitutional changes to have the support of three-quarters of the legislature and a majority of voters in a referendum. In Taiwan's current political makeup, this would make it all but impossible to adopt a constitution making independence explicit.

Mr Chen says that after 2008, when his term ends, he wants to be remembered as having protected Taiwan from being annexed by China and becoming “a second Hong Kong”. For all its sometimes menacing talk, China does not appear anxious to prevent him fulfilling his wish.

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Pakistan

Madrassa maths

May 19th 2005 | ISLAMABAD
From The Economist print edition

An alleged boom in Islamic schooling may have been overstated

Reuters

Not necessarily extremists

Get article background

PERVEZ MUSHARRAF, Pakistan's president, this week let it be known that he would like to stay in power even after his current term expires in 2007. Supporters of the general, who seized power in a bloodless coup in 1999, have long been campaigning for this outcome. They present their man, who preaches a gospel of “enlightened moderation”, as a bulwark against Islamic extremism—whose rise, in this traditionally moderate Muslim nation, gives America nightmares.

Opinions differ sharply, however, over how serious a threat extremism really poses to Pakistan. True, a group of Islamist parties did better than ever in elections in 2002. But they still won only 11% of the votes. Similarly, a debate over the growth of *madrassas* (Islamic schools) suggests their popularity may be exaggerated.

The *madrassas* vary widely in their curriculum, aims and doctrine. Most have no links with extremism at all. “It is a figment of the imagination that they are a factory for terrorism,” says Khurshid Ahmad, a senator from a leading Islamist party. But many of the Pakistani *jihadis* who fought in Afghanistan in the 1980s and early 1990s against the Soviet army, with the Pakistan-sponsored Taliban and then in Indian-controlled Kashmir, were products of a *madrassa* education.

Their wars seemed to help popularise Islamic education. According to research by the Institute of Policy Studies, a think-tank chaired by Mr Ahmad, the number of *madrassas* increased from 2,861 in 1988 to 6,761 in 2000. It is widely reported that *madrassa* education has boomed since the September 11th attacks on America and the “war against terror” that followed. In November 2003, Pakistan's education minister estimated the number of *madrassas* at between 15,000 and 20,000. One report suggested that one-third of all Pakistani children were enrolled in *madrassas*. That seems to be far from the truth.

Recent research* for America's Harvard University suggests that during the 1990s enrolment in *madrassas* increased by only 16%—less than the increase in overall school enrolment. So the proportion of children in *madrassas* actually fell. The data considered come from three sources: a national census in 1998, household surveys and a special educational census conducted in 2003 in three districts of Punjab province. The authors admit that they might understate *madrassa* enrolment: orphans would be excluded; so may those children who attend a *madrassa* part-time. Even correcting for this, however, *madrassas* account for less than 1% of total enrolment nationwide, and still less than 2% in the areas

where they are most prevalent, near the border with Afghanistan.

These numbers imply that the danger of a radical Islamisation of Pakistan is less acute than is often assumed. They do not, however, answer two criticisms of the government: that it has not lived up to its promises to regulate *madrassas* properly, or to close down all of those few that do have proven links to extremist groups.

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* "Religious school enrolment in Pakistan: a look at the data", by Tahir Andrabi, Jishnu Das, Asim Ijaz Khwaja and Tristan Zajonc, John F. Kennedy School of Government

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About sponsorship

Australia and East Timor

Fair dinkum

May 19th 2005 | SYDNEY
From The Economist print edition

Australia, at long last, does the right thing by East Timor

Get article background

SINCE East Timor won independence in 2002, the world's newest nation has been locked in a bitter dispute with its rich neighbour, Australia, over access to big oil and gas reserves beneath the Timor Sea. But as East Timor approached the third anniversary of its independence on May 20th, the saga seemed to be heading for a happy ending.

In talks that finished in Sydney on May 13th, the two countries at last managed to break free of their two main sticking points: where to draw their maritime boundary, and how much revenue East Timor should receive from the oilfields and gasfields. East Timor now stands to gain half the government revenue from Greater Sunrise, the main gasfield in dispute, rather than 18% under an earlier plan. As for the maritime boundary, the two countries agreed to leave that for a new generation to solve by deferring it for 50 years.

Australia was a midwife to East Timor's birth by leading a multinational force that oversaw its transition to independence. Relations soured when East Timor objected to the way Australia and Indonesia had carved up the Timor Sea's resources in 1989, when Australia was one of the few countries to recognise Indonesia's occupation of East Timor. Most known resources lie in the Joint Petroleum Development Area (JPDA), a zone once known as the Timor Gap, where hydrocarbon revenues are shared by the two countries. But Greater Sunrise, the most lucrative known field, lies mostly outside the JPDA, inside Australia's maritime boundary as Australia and Indonesia had drawn it. This gives Australia 82% of Greater Sunrise's revenue, leaving East Timor 18%.

East Timor wanted the boundary to be redrawn to a half-way point with Australia. This would have located most of the JPDA—and all of Greater Sunrise—squarely in East Timor's waters. When Australia said no, East Timor proposed that the JPDA's boundaries be expanded in such a way to increase its revenue from Greater Sunrise. Australia said no again. But earlier this year, East Timor proposed a new

idea: to set aside the boundary dispute and agree to split Greater Sunrise's revenue equally. This became the formula for a breakthrough at talks that resumed in Dili last month and wound up in Sydney. It marks a big concession by the Australian government, which was being damaged by accusations of miserliness. Australians are largely sympathetic towards East Timor's long struggles against hardship.

East Timor has already started receiving some of the $8 billion in revenue estimated to come its way from the Bayu-Undan gas field inside the JPDA. Assuming that both countries ratify the new deal on Greater Sunrise, East Timor will gain up to $5 billion more than its original revenue share from that field over its estimated 30-year life—though that will depend on oil and gas prices. It could be much more.

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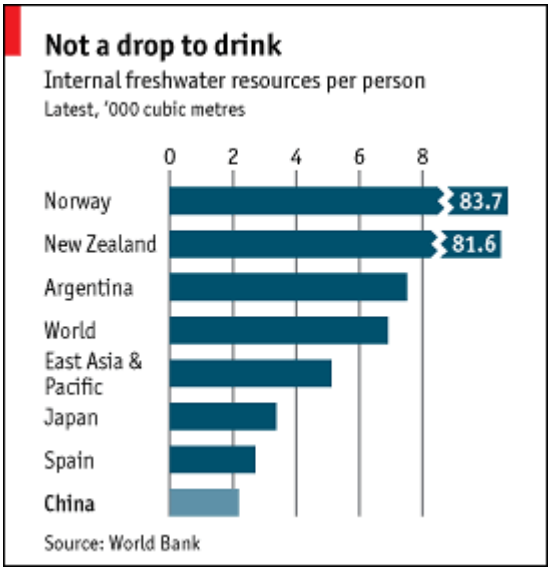
China and water

Drying up

May 19th 2005 | BEIJING
From The Economist print edition

The Chinese must act fast to conserve their country's shrinking water supply



AS A deputy prime minister in 1999, Wen Jiabao warned that the very “survival of the Chinese nation” was threatened by looming water shortages. Mr Wen has since taken over as prime minister, and earned robust applause in parliament this spring when he promised “clean water for the people”. To that end, his government says it will spend an extra $240m this year. But this is a drop in the ocean. Never especially blessed with water, in recent years China has seen its supplies fall to dangerously low levels as it faces drought, rising demand and the combined effects of decades of pollution and misguided policies. Senior officials and international agencies are equally gloomy.

One in three country-dwellers in China lacks access to safe drinking water. More than 100 big cities, of which half are deemed “seriously threatened”, are short of water. Water tables are dropping by a metre or more every year across much of northern China. Even in Beijing, supply per head now stands at a perilously low 300 cubic metres (66,000 gallons) a year. Reduced flow rates on China's greatest rivers have made hydro plants reduce badly needed power output: many smelters, paper mills and petrochemical plants are no longer sure of getting the huge amounts of water they require. Droughts, historically more common in northern China, are now hitting the south too. This year Guangdong province, home to 110m people, has had a 40% drop in rainfall.

Misguided pricing policies have made matters a lot worse. Until 1985, most users were not charged at all, so it made little sense for enterprises to invest in treatment and recycling technology or for farmers to fret about wasteful irrigation. Water prices in China have risen only slowly in the past 20 years and are still among the world's lowest. Most Chinese water is bought at around 40% below cost. Even in parched Beijing, city officials are hesitating to press ahead with planned increases to the break-even point of around six yuan ($0.72) a cubic metre. Nationwide, prices are set at different levels for different sorts of users by a jumble of local and central bureaucracies, all wary of slowing economic growth.

John McAlister, head of AquaBioTronic.com, a water-recycling firm, says China is committing “ecological suicide” with its current policies and should put prices up to 20-40 yuan a cubic metre. He argues that foreigners ought to take the lead in arguing for such increases if they hope to continue to benefit from China's economic boom. Alas, he has had as much trouble convincing foreign firms of the urgency of

China's water crisis as he has had convincing Chinese firms to invest in his technology.

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Ethiopia

A taste of democracy

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From The Economist print edition

AP

Last week's election was Ethiopia's freest ever. But does the country deserve a doubling of aid, as some argue?

AT ELECTIONS on May 15th, Ethiopians were offered a real choice. Opposition parties fielded more candidates than ever before. The state broadcaster aired proper political debates. Foreign observers were welcomed. A week before the vote, opposition supporters—maybe more than a million—were allowed to march in Addis Ababa, the capital.

It was the freest election ever held in Ethiopia, though that is not saying much. In the past 3,000 years, the country has spawned great civilisations, but nothing resembling a modern democracy. Only 14 years ago, it was under the grip of a Marxist regime, the Derg, whose leaders thought mass starvation a useful tool both for crushing rebellious tribes and for easing overpopulation.

Since the Derg fell in 1991, Ethiopia has become a less harsh and more open society. Western donors see it as a test case for the argument, advanced by Britain and others in the run-up to the G8 summit in July, that a doubling of aid could help lift Africa out of poverty. The theory is that aid yields the best results if directed at moderately well-governed countries with lots of poor inhabitants. With 71m people, Ethiopia is by far the most populous country in the bottom tenth of the UN's Human Development Index, a composite measure of poverty, ill health and basic education. (In 2004, it was ranked 170th out of 177.)

Under Meles Zenawi, who toppled the Derg and now rules pragmatically as prime minister, Ethiopia is doing better. Tony Blair, Britain's prime minister, thinks so highly of Mr Zenawi that he asked him to sit on his Commission for Africa. Donors believe that with more help (Ethiopia already gets $1 billion a year, excluding food aid), the country could take off.

With aid, however, comes scrutiny. Donors prefer their clients to be democratic, and Ethiopia is imperfectly so. The ruling coalition, the Ethiopian People's Revolutionary Democratic Front (EPRDF), enjoys vast powers of patronage. The state owns all the land in Ethiopia. Peasants are therefore reluctant to upset anyone in a position of power for fear of being evicted, and some 85% of Ethiopians are peasants.

One of two newly formed opposition groups, the Coalition for Unity and Democracy (CUD), offered a liberal alternative: campaigning, among other things, for land to be privatised. It did well in cities, winning all 23 seats in Addis Ababa, but has found it harder to sway rural voters.

Lalibela, a small town two days' drive north of Addis, saw a typical campaign. The first opposition candidate in the area, Destaw Kassie Gobezie, canvassed on foot because he had no car. With some polling stations as far as 95km (60 miles) away, however, he could not reach everyone. An old salt-seller in Lalibela's market told *The Economist* that he did not know who the candidates were. He said he would ask for advice at the polling station.

The opposition complained of harassment and vote-buying, particularly in the countryside. Human Rights Watch (HRW), a pressure group, says that repression and intimidation in Oromia, the country's largest region, rendered the vote there a “hollow exercise”. HRW claims that torture and arbitrary arrests, aimed at crushing a local revolt, have also silenced peaceful dissent. Teachers have been made to spy on students, local officials have been made to spy on peasants and suspected “troublemakers” have been prevented from receiving public services, such as medicine. The minister of information dismisses such allegations as smears.

Vote-counting is expected to continue until June 8th, but the ruling coalition was confident enough of having swept rural areas to declare victory on May 16th. Two days later, the CUD retorted that on the contrary, it was on course for a famous victory. The prime minister has banned rallies in the capital for a month.

Which side is really more popular is hard to say. The EPRDF gets credit for having ousted the Derg, and for delivering schools, roads, water and electricity to many over the past decade. But the lack of secure property rights has hindered the development of larger, more productive farms. A year of poor rains still translates into millions of people needing food aid and a contraction of the whole economy. Irrigation is still rare, and the proportion of Ethiopians living in absolute poverty has fallen only slightly—from 45.5% in 1996 to 44.2% in 2000, according to the IMF. Over the past two years, however, the rains have been good and the economy has rebounded, growing by over 11% last year.

Sandwiched between warring Sudan and disintegrating Somalia, Ethiopia looks admirably stable. But its border dispute with Eritrea, which exploded into a disastrous war in the late 1990s, remains unresolved. Although the border was delineated by a UN commission in 2002, it remains unmarked, and both countries continue to threaten each other. This imposes a huge cost in defence spending and lost trade.

Ethiopia is an ethnic and religious mosaic, with 80 languages and a history of local revolts. To ease tensions, the government has opted for a decentralised federal system, with nine regions drawn along ethnic lines, and has even included the right to secede in the constitution. The opposition, however, argues that this actually aggravates divisions.

Many also believe, resentfully, that the government is dominated by Mr Zenawi's ethnic group, the Tigrayans, who spearheaded the revolt against the Derg. During the campaign, the prime minister likened the opposition's thinking to that of the *Interahamwe*, the militia that carried out the Rwandan genocide of 1994. That is ridiculous, but it suggests that Ethiopia's stability cannot be taken for granted. The love affair between western donors and their latest darling could yet prove stormy.

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Namibia's nascent film industry

Star of Africa

May 19th 2005
From The Economist print edition

A blockbusting biopic about a big man with a beard

AP

It'll be the greatest story ever told

THERE is a limit to how many films a small country can subsidise. So the cultural commissars in Namibia, a south-west African nation of 1.8m, have had to be choosy. Luckily, they stumbled on a sure-fire hit: ex-President Sam Nujoma's autobiography.

It's called “Where Others Wavered”. It tells of the great man's long armed-struggle to free his country from colonialism. It has the potential to “kick-start a major movie industry in Namibia”, according to Johannes Tjitjo, the head of the Pan Afrika Centre of Namibia. Addressing a press conference last month, he added that it would “empower a lot of Namibians” and “put the country on the map”.

Shooting was supposed to start last week, but was delayed owing to confusion as to which arm of government was to stump up the cash. Eventually, some money was found. But even with the help of Hollywood stars such as Danny Glover (who plays a priest), can a dramatisation of a plonking 476-page memoir put bums on seats? In the book, no revolutionary meeting was deemed too dull for inclusion. With luck, the film script is snappier.

Another of the book's oddities is that, although it was published in 2001, after Mr Nujoma had been president for a decade, it did not bother to describe anything he did while in power. A sequel is surely required, though it could prove anti-climactic. Mr Nujoma ruled neither well nor badly for 15 years. Namibia is stable, and richer than the African norm. Mr Nujoma retired in March, but many Namibians suspect he still sits, as it were, in the director's chair.

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Iraq's constitution

Now get drafting

May 19th 2005 | BAGHDAD
From The Economist print edition

It may be easier for Kurds and Shias to get along than to satisfy Sunni Arabs

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AP

Saadoun al-Dulaimi: lay off the mosques

WITH Iraq's government at last up and running, parliament is getting down to the business of drafting a permanent constitution. But while that could take another nine months of wrangling, the spectre of sectarian violence still looms. In the past week, the bodies of some 15 Sunni Arabs who were members of the influential Muslim Scholars' Board or related to them, including four preachers, have been found ditched, mostly on the edge of Baghdad. In turn, the bodies of some 50 others, mainly Shias, have been found in similar places, they too apparently victims of sectarian killings, many with bullets in the back of the head, execution-style.

More than a score of car-bombings have hit Baghdad alone since the government took shape three weeks ago, killing nearly 500 Iraqis, though this week the rate went down a bit. In return, relatives of the Scholars' Board, which has generally endorsed the insurgency (but some of whose members say the insurgents should now stop fighting and engage in peaceful politics), accuse Iraqi interior-ministry commandos of targeting Sunni families suspected of links to the rebels.

On her first visit to Iraq since becoming secretary of state, Condoleezza Rice this week urged the new government, dominated by Shias and Kurds, to reach out to the disaffected Sunni community. And the new defence minister, Saadoun al-Dulaimi, himself a Sunni Arab, said that counter-insurgency troops, presumably including the Americans, should not barge into mosques, even if insurgents seemed to be seeking refuge in them, for fear of sowing further sectarian hatred.

The 55-strong constitution-drafting committee has been drawn from the main parties in proportion to their tally of seats. So the dominant Shia-led United Iraqi Alliance has 28 members; the Kurdish coalition has 15; the mixed Sunni-Shia secular nationalist party of the outgone prime minister, Iyad Allawi, has eight; four other spots have been filled by a Communist, a Turkmen, a Christian and a Sunni Arab.

According to the Transitional Administrative Law (TAL), the interim constitution approved by unelected Iraqi politicians last year, the parties have until August to produce a draft of a permanent version, to be presented to parliament for approval, then submitted to a popular referendum. If approved, a fresh general election will be held under the new constitution—and the Iraqi government that emerges will no longer be deemed transitional.

If the committee cannot produce a draft by August, it can ask for a six-month extension, but the Americans want the job done sooner rather than later. This, they argue, would sustain the political momentum and make the insurgents realise that Iraq's new system is there to stay. Moreover, the sooner the new elections, the sooner that Sunni Arabs, who make up the bulk of the insurgents and who largely stayed away from the poll in January, will have a chance to take part in peaceful politics.

Many Iraqis say this timetable is unrealistically tight. A controversial clause in the TAL allows two-thirds of the voters in at least three of Iraq's 18 provinces, notably the trio that makes up the Kurdish region in the north, to veto a proposed constitution. This means that pretty well every main party will have to agree to the draft for it to have a chance of being endorsed.

There is much mistrust between the two major blocks—the Shia alliance, led by religious parties, and the more secular-leaning Kurds. But they have made progress. Both have agreed to use the TAL as the basis for the draft, even though some Shia Islamists had previously argued that they had accepted the document only under American pressure and that it had given too much ground to the Kurds. But thanks to earlier debates over the TAL and during the formation of the cabinet, some of the most divisive constitutional issues may already have been resolved. For example, many Shia Islamists now accept the TAL's wording that Islam should be *a* source rather than *the* source of Iraqi law.

It also provides a road map for settling the dispute over the status of the northern province and city of Kirkuk, a big cause of discord between Kurds and Shias. During Saddam Hussein's Arabisation of the area, which peaked in the 1990s, Kurds were ejected from the oil-rich province and replaced by Arabs, mostly from the impoverished Shia south. But the main Shia leaders now seem to accept the TAL's blueprint for resettling both Kurds and Shias (with compensation) in their original homes.

Committee members expect the issue of federalism to spark the fiercest debates. The Kurds, who have enjoyed de facto independence in their northern autonomous zone since the Gulf war of 1991, are willing to discuss the sharing of revenues from the northern oilfields but do not want people in the capital meddling in their internal affairs. Most Shias say they must draw the line at anything that might lead to the partition of Iraq. Between these two views, however, lies quite a lot of room for manoeuvre. Though initially hostile to the idea of federalism, Shia public opinion may be coming round to it, largely due to the efforts of Shias from the oil-rich but impoverished southern province of Basra, who want to ensure that their riches are no longer siphoned off to the capital.

The Americans, meanwhile, are anxious to get more Sunni Arabs involved in writing the constitution. One problem is that the Sunni Arabs, themselves divided, have yet to articulate what kind of system they want, except to rule out any kind of federalism that would leave their oil-poor provinces starved of funds. Other Sunni groups have yet to sound willing to engage in the necessary give-and-take of constitutional debate. The Muslim Scholars' Board has rejected in advance any version based on the TAL or any other “western” model; it says it will draw up its own constitution based solely on Muslim legal tradition.

So far, then, there are signs that Shias and Kurds may resolve their differences over a constitution. But any hope that the Sunni Arabs will easily join the debate, so undercutting the insurgency, is a long way from fulfilment. Meanwhile, the chance of sectarian warfare may be increasing.

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Iraq's Kurds

Now stop bickering

May 19th 2005 | ARBIL
From The Economist print edition

The Kurds must put their own house in order if Iraqi federalism is to succeed

Get article background

THE Kurds were delighted that America's secretary of state, Condoleezza Rice, stopped off first in their own quasi-independent region on her way to Baghdad. She was welcomed by Massoud Barzani, head of the Kurdistan Democratic Party (KDP), one of two groups that run the show. But less rosy, from the Kurdish point of view, was a renewal of discord between the KDP and its old rival, the Patriotic Union of Kurdistan (PUK), run by Jalal Talabani, now Iraq's national president. Since a national government has at last emerged three months after a general election, the Kurds are supposed to have formed a new government in their own region, with Mr Barzani as its president, but they are painfully failing to do so.

The Kurdish assembly, often cited as a model for the rest of Iraq, has yet to reconvene. Under a deal struck in December between Messrs Barzani and Talabani, it was agreed that the latter would go to Baghdad after January's election and seek one of Iraq's high offices of state; he duly got the presidency. Mr Barzani would stay up north as the Kurdish region's president. But the two parties are now arguing over his powers and responsibilities.

The Kurdish parliament's first session since the January election was due to start on April 30th but has yet to do so. Honoured guests, many of whom had been twiddling thumbs and sipping tea for weeks in the lobby of Arbil's fanciest new hotel have drifted away.

Mahmoud Othman, a veteran Kurdish politician who has been trying to mediate, explains that the two parties agreed in principle that Mr Barzani should become the region's president on the basis of December's “gentleman's agreement”. But nobody had worked out the details. Senior PUK and KDP people have locked horns over the regional president's powers, method of election and duration of mandate. Broadly speaking, the KDP wants a stronger presidency for their man, while the PUK wants a more ceremonial one, a bit like the national one in Baghdad.

To the delight of most Kurds, the two leaders had previously announced that the KDP and the PUK would unify their twin administrations at the first meeting of a freshly mandated Kurdish parliament. This would be a big step. In the mid-1990s Iraq's Kurds fought each other in a fratricidal civil war. This ended in 1998 when the Americans helped broker a deal whereby the PUK would run the eastern and south-eastern part of Iraqi Kurdistan from Sulaymaniyah, while the KDP would control the north and west from Arbil, now the overall region's capital.

Haunted by the prospect of another bout of fratricide, with each party controlling large militias, ordinary Kurds are twitchy. “Kurdistan is Iraq's most stable area and our economy is doing well,” says a lecturer at Arbil's Salaheddin university. “Shall we throw away all we've won because of these two parties?”“How can Kurds go to Baghdad to fight for a federal region, when we can't unite ourselves?” asked an exasperated local official. “How can we ask for [the disputed city of] Kirkuk? The Arabs will just laugh at us.”

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Saudi Arabia

The suffocating limits of reform

May 19th 2005 | CAIRO
From The Economist print edition

Despite promised political change, liberals are still getting locked up

A FEW short weeks ago, Saudi Arabia looked well on the road to recovery from the public-relations disaster of September 11 2001. Robust policing appeared to have broken *jihadi* cells within the kingdom. The holding of partial elections for town councils showed its rulers were not deaf to charges that autocracy breeds extremism. The warmish Texas welcome given by George Bush to Crown Prince Abdullah, the acting Saudi leader, augured an easing of tensions between the superpower and the world's biggest oil supplier.

But the kingdom's darker side has a way of emerging to cast shadows over the brightest hopes. This week a Saudi court—in fact, a panel of Islamic jurists—condemned three prominent liberals to between six and nine years behind bars. It was not only the harsh terms that shocked Saudi Arabia's many would-be reformers. Just as discouraging were the trial's procedure and the wording of the verdict.

The three men, a poet and two professors, were among 13 intellectuals arrested in March last year, shortly after calling publicly for Saudi Arabia to evolve into a constitutional monarchy. Fear inspired by their arrest abruptly halted what had been a growing movement among liberals politely but insistently to petition senior princes for reforms. In subsequent months, ten of the dissidents were freed after signing promises to stop making public demands or talking to the foreign press.

But the remaining trio, Ali al-Domeini, Abdullah al-Hamad and Matruk al-Faleh, refused to sign away their freedom of speech. After one public hearing, in itself considered a breakthrough for the opaque Saudi court system, judges not only closed the trial to outside scrutiny but threw out part of the defence team. In November, Abderrahman al-Laham, a defence lawyer who himself had been one of the original 13 defendants, was rearrested for breaking his pledge of silence. He remains imprisoned without trial.

Among the three men's “crimes” cited by the judges was their description of the kingdom's educational system and Wahhabi religious ideology as causes of extremism. With no hint of irony, the court also accused them of having “breached the foreign media” and “plotted to stir up the masses, so allowing the nation's enemies to slander it.”

The sentences can still be appealed, and some suspect that a royal pardon may be in the works. Yet the hazards of even mild dissent have increased a sense of beleaguerment among Saudi liberals. Last year, the government banned its employees, which means most adult Saudi males, from criticising the state. The recent local polls, which produced big wins for religious conservatives, showed the low esteem in which the secular-minded are held by many Saudis. Striking, too, have been recent clerical rulings, such as one decrying the “debauchery” of a popular talent show on satellite television that happened to be won by a young Saudi.

Although most Saudis are repelled by the violence of *jihadi* youths, whose attacks in the kingdom have killed some 100 people in the past two years, religious radicalism still attracts recruits. Rather than fight at home, however, many—some say a good 2,500 in the past two years—have headed to Iraq. Almost daily, Saudi newspapers report the death in action of Saudi *jihadis*. One radical website has clocked over 400 such “martyrs” in Iraq, the bulk of them Saudi. Other web postings offer useful advice to volunteers, such as the proper way for prospective martyrs to perform ablutions, should they happen to be captured or lose a limb.

In other words, while the Saudi state's all-out security and publicity campaign against terrorism has lessened local dangers, it has not much dented the zeal for *jihad*. The world-view cultivated in schools and mosques and religious broadcasting remains paranoid, portraying the kingdom as an Islamic citadel

besieged by enemies, be they deemed home-grown secularists, terrorists or hostile foreign powers. Try to explain that things may be different, and you just might end up in jail.

None of this means that reforms will stop. There are other forces for change in the kingdom, such as business interests (Saudi Arabia is pushing for membership of the World Trade Organisation) and media exposure to the rest of the world (where, for example, women in neighbouring Kuwait have just won the right to vote). Next week the Shura Council, the Saudis' unelected but sometimes feisty proto-parliament, is set to debate the hitherto taboo issue of letting the country's women drive cars.

However, with outside political pressure lessening and the kingdom's coffers swollen by high oil prices, the ruling House of Saud may think it is in a position to move only as fast as it wishes.

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Yemen

A Shia shadow

May 19th 2005 | SANA
From The Economist print edition

The government says it has crushed a revolt with roots abroad

Get article background

MILITANT Sunni groups may be commonplace in violent Yemen but, for the past year, the government has also been fighting a Shia revolt in the country's remote north. The revolt, by a group called Believing Youth, started last year but died down after its leader, Hussein al-Houthi, a religious figure who was once a member of parliament, was killed. It was resurrected at the end of March under the leadership of Hussein's 86-year-old father, Badreddin al-Houthi, who is still on the run. The government now says it has squashed the revolt, which it further claims was encouraged and supported by Iran.

Yemen is predominantly Sunni but 35% of the population belong to the Zaydi Shia sect, a moderate school of Islam unique to Yemen. Zaydi leaders denounce the rebels, who they claim are influenced by Iran. The theory is that Iran, encouraged by the new Shia ascendancy in Iraq, is trying to spread its faith, while simultaneously damaging the Yemeni government and its American patron. Grand Ayatollah Ali al-Sistani, Iraq's leading Shia cleric, raised the temperature by accusing Yemen of trying to extinguish its Shia community.

Both Sunni and Shia rebels resent the close new link between Yemen and the United States. In return for aid, Ali Abdullah Saleh, the country's president since 1978, has been a resolute ally in the war on terror. (Eight people unlinked to the latest unrest—five Yemenis, two Syrians and a Kuwaiti—are on trial, accused of belonging to al-Qaeda and trying to kill the prime minister.) Government sources say that the Shia rebel leaders have been preaching violence against both the United States and Israel at mosques throughout the country. They seem to be well supplied with money, apparently from abroad—money that can quickly be converted into guns.

Indeed, the current uprising started at the end of March when the police questioned a group shopping at one of the many weapons bazaars outside Sada, near the porous Saudi border. The group turned on the police. A shoot-out was followed by rebel attacks on military camps and government buildings. Last summer saw intense fighting in the mountainous terrain of Marran, where the insurgents were entrenched.

According to the interior minister, 525 soldiers and civilians have been killed in last summer's fighting and during the recent resurgence. Since neither the media nor aid organisations were allowed into the area, such figures have been hard to corroborate through independent sources, but reports from the

closed-off zone have described hospitals full of injured people.

Some fear a deeper religious crack in a country where tribal politics run like lacework through society. It suits the government to blame outsiders, particularly Iran, but its own unpopularity may help rebels to recruit Zaydis who are not yet militant.

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German politics

Eyes on North Rhine-Westphalia

May 19th 2005 | HERFORD, NEAR BIELEFELD
From The Economist print edition

AP

A crucial state election may settle Chancellor Gerhard Schröder's future

Get article background

IMAGINE you are a popular leader of one of the bigger European countries. What scenario might make your re-election all but impossible? Record unemployment of over 12%, and twice that in some of your strongholds, might do. Add in billions in public debt, lousy schools and rising crime—and even many of your most ardent supporters could stay at home or vote for the opposition.

This essentially describes the political predicament of Peer Steinbrück, the Social Democrat (SPD) premier of North Rhine-Westphalia, Germany's most populous state, which is holding elections on May 22nd. Yet last week, stumping in Herford, a city of 65,000 in the state's north-east, he did not come across as a loser. Yes, the state faces big problems, was his message, but we have better people and a programme to solve them. It was even delivered with a dose of self-deprecating wit. The crowd seemed to like what it heard.

A couple of hours later, and a mere stone's throw away, the Christian Democrat (CDU) challenger, Jürgen Rüttgers, had a harder time. Although his event organisers had arranged for rock music to greet the candidate, and party activists acted as cheerleaders, he did not connect with his audience. Instead of explaining what he would do differently, the former federal research minister stuck to lines that go down well, such as a promise to make sure that schoolchildren again learn how to read and write.

Mr Rüttgers is still likely to win, although a third of voters are undecided and recent polls have shown a narrowing gap between the CDU-Free Democrat opposition and the SPD-Green government. But whatever the outcome, it will shake up the political landscape, both in North Rhine-Westphalia and at federal level. In a way, this election is the German equivalent of France's referendum on the European Union constitution a week later.

The size of North Rhine-Westphalia means that it is more than just another regional election. NRW, as its citizens call it, has not only the biggest population (with 18m inhabitants), but also the EU's fifth-largest

economy (ahead of the Netherlands, behind Spain). Moreover it is the heartland of the SPD, which has been in power there for almost four decades. Losing the state would be almost as historic an event as seeing the Christian Social Union, the CDU's sister party, kicked out in Bavaria, which it has governed since 1957.

The comparison with Bavaria is instructive on another level. The southern state has developed from a mostly agrarian economy into a high-tech hotbed in recent decades. But NRW has declined, mainly because of the collapse of heavy industry and mining. The number of coalminers in NRW has fallen from 500,000 in the early 1960s to 38,000 now. But SPD-led governments are also to blame. Although they built universities and attracted some new industries, they wasted a lot of money trying to put off or cushion inevitable structural changes.

Whichever candidate takes the helm in NRW will have his work cut out. Avoiding fiscal collapse, improving schools and, perhaps most important, changing people's habitual reliance on the state for help will all be big challenges. But change is sure to be slow, which may explain why Mr Rüttgers has been so hesitant over making far-reaching promises.

On the federal level in Berlin, though, the fallout from the vote will be felt far sooner. Angela Merkel, the CDU's chairman and opposition leader, can relax. It would now be bad news for her if Mr Rüttgers were to lose; but the ensuing ferment might also speed up the process of her being made the opposition candidate for chancellor. And she need not worry too much about the arrival of Mr Rüttgers, who is something of a softie on economic reform, as a new power to reckon with. For Ms Merkel has herself largely given up on the idea of running in next year's federal election on a radical reform agenda.

For the governing SPD-Green coalition, on the other hand, a defeat in NRW would be an unmitigated disaster—although thanks to the SPD's relative success in other recent state elections, it will still avoid the calamity of a two-thirds opposition majority in the upper house, the Bundesrat, which could have blocked almost all legislation, even the budget. But losing NRW will increase the pressure within the SPD to change course. The party's left wing—encouraged by remarks by Franz Müntefering, its chairman, who has criticised global capitalism and called international investors “locusts”—is sure to push for measures to water down Chancellor Gerhard Schröder's Agenda 2010 reforms, passed last year.

More significantly, a loss of NRW could mark the beginning of the end for the SPD-Green alliance. The two parties would have lost all centres of power except for the lower federal house, the Bundestag. Already, they are moving in different directions. Even as the SPD lurches back towards its Social-Democratic roots, the Greens seem tempted to sharpen their own profile, for instance over the arms embargo on China, which they want to keep, or over homeland-security measures.

But do not expect anything drastic to happen yet. Mr Schröder is unlikely to resign or form a grand coalition with the CDU, for instance. The SPD has no other credible candidate for chancellor and the CDU would not join a grand coalition under his leadership. More likely, Mr Schröder will move left, but not enough to endanger his reforms. Later this year, he may reshuffle his cabinet, replacing Hans Eichel, his finance minister—perhaps with Mr Steinbrück, if he needs a job.

Such political manoeuvring notwithstanding, a loss in NRW will leave Mr Schröder looking increasingly like a lame duck. But with Joschka Fischer, Germany's Green foreign minister, seriously weakened by the

visa scandal, Mr Schröder will still be the coalition's only chance to hold on to power in 2006. And, as his supporters love to point out, he is always at his best with his back to the wall.

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Political mistakes

Teeth, booze and Ukrainian women

May 19th 2005 | BERLIN
From The Economist print edition

A gaggle of German gaffes

Get article background

COULD it be that the strain of keeping a stiff upper lip during the second-world-war commemorations has proved too much? That might at least partly explain a string of recent gaffes in Germany—going far beyond the notorious comparison of foreign investors to “locusts” made by Franz Müntefering, the Social Democrats' chairman.

That Jews take their burial traditions seriously should not be news to somebody who has made a career out of ensuring that Germans do not forget the Holocaust. But when Lea Rosh gave a speech at the inauguration of Berlin's new Holocaust memorial, she stunned the audience by brandishing a molar she found 17 years ago at Belzec, a Nazi concentration camp, and saying she would set it into one of the memorial's 2,711 concrete pillars. It did not take long for Jewish leaders to express outrage and threaten to boycott the site—and for a reluctant Ms Rosh to abandon her idea.

Peter Gloystein's *faux pas* was less insensitive, but it still cost him his job. After opening a wine fair and a magnum of bubbly, the economics minister of Bremen proceeded to douse a homeless person, saying “here is something for you to drink as well.” When the victim burst into tears and threatened to press charges, Mr Gloystein made things worse by offering him first some money, then a Mont Blanc pen, then a night in a luxury hotel, and finally a two-week holiday.

Kurt Faltlhauser is unlikely to resign, but Bavaria's finance minister has clearly outed himself as a male chauvinist pig. After tapping a keg of traditional May beer at a festival, he gave the audience of several hundred a taste of raunchy Bavarian humour. Referring to the recent visa scandal, which has allegedly allowed many Ukrainian prostitutes to come to work in Germany, he noted that there was still much unfulfilled demand, particularly in Bavaria; as he put it, “each state has the right to the skills of freedom-loving Ukrainian women.” He went on to pledge that when Edmund Stoiber, Bavaria's premier, is at last elected chancellor, “beer and women will get even cheaper.”

Pessimists might interpret all this as a sign that Germans are losing their normally impeccable sense of tact. Most onlookers could only cringe.

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France

Monsieur Hulot's non-holiday

May 19th 2005 | PARIS
From The Economist print edition

A row over Pentecost further sours the French public's mood

AP

Hands off our holiday

"IT'S not solidarity, it's a rip-off," said the Confédération Générale du Travail (CGT), France's biggest (and also communist-backed) trade union. The government's decision to scrap the Pentecost public holiday, on May 16th, was meant as a gesture of solidarity towards the elderly. It ended up in confusion and resentment—another botched reform to increase the country's malaise ahead of its referendum on Europe's constitution on May 29th.

Jean-Pierre Raffarin, France's centre-right prime minister, had originally decided to sacrifice this public holiday after the summer *canicule* (heatwave) in 2003, in which 15,000 people died, many of them elderly. Rather than squeezing more money out of existing budgets, the idea was to raise €2 billion ($2.5 billion), largely through a one-off 0.3% payroll tax levied on the extra day of work. Employees would work without extra pay; in return, no income-tax hike was threatened. So rocked were the French by the *canicule* that the plan passed with little protest.

Had it been clearly explained and uniformly implemented, the matter might have rested there. But confusion reigned. For a start, the law applied only to employees; farmers, doctors, shopkeepers and other self-employed people were free to keep their day off. Then the unions decided to make a stand. "The non-remuneration of work is illegal," declared the CGT. "It is not for employees to pay for the negligence and disengagement of the government over its health policy." Strikes were called among postal workers, teachers, bus drivers and air-traffic controllers. Sensing trouble, some companies—and public-sector bodies—gave staff a day off anyway. Surreally, the state railways gave staff a holiday, in exchange for working one minute and 52 seconds extra each day.

The upshot was, as the French put it, *une pagaille*: a shambles. The government claimed that a majority had turned up to work, but that still left millions on holiday. Most schools were open, but some sent children home at lunchtime for lack of catering staff. Post offices opened, but most counters inside remained shut. The Paris metro worked as normal, but only because employees were paid a bonus to turn up—on what was supposed to be an ordinary working day. Public transport in such cities as Lille, Strasbourg, Dijon, Bordeaux and Marseilles was sparse. "Half of France has gone to work, while the other half has created a mess for everybody else," complained one businessman, delayed for nearly two hours at Bordeaux airport for want of air-traffic controllers.

Were the government less weak, this saga might have been turned into a symbolic victory. After all, in the land of the 35-hour week, this was for once a reform that required the French to work more, not

less—and for no extra pay. “The unions know that, if the French accept this principle, it could set a precedent,” comments one minister. France has a particular need to keep the over-55s, for example, behind their desks for longer in life.

Yet, ahead of the referendum, the government is shying away from any confrontation. Officially, the referendum campaign began only this week, but policymaking has been on hold for weeks. Some two-thirds of French voters are against making Whitsun a working day. This week, the no vote rebounded in the polls to over 50%—the third time the yes and no lines have crossed since mid-March. With such discontent and clumsy leadership, the chances of a “non” look real.

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Spain and ETA

Peace talk

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From The Economist print edition

The Spanish government is preparing to talk to the Basque terrorists

Get article background

SPAIN'S Socialist prime minister, José Luis Rodríguez Zapatero, set off this week in search of the holy grail of Spanish politics: to negotiate the disbandment of the Basque terrorist group, ETA. And a risky adventure it could prove to be.

The government got the Cortes (parliament) in Madrid to pass a motion supporting “dialogue between the competent authority within the state and whoever decides to give up violence.” The vote was 192-147, with the government winning backing from regional nationalists and other leftist parties. Only the opposition People's Party (PP) voted against, accusing Mr Zapatero of “betraying the dead” and “surrendering parliament”. The PP's leader, Mariano Rajoy, asked Mr Zapatero to spell out the political price that would have to be paid for a deal with ETA.

The motion is explosive, as it runs against the hardline policy adopted by Mr Zapatero's PP predecessor, José María Aznar (though Mr Aznar earlier tried direct negotiations too). It has stirred up an emotive debate centred on victims of ETA terrorism, who plan to stage a protest in Madrid next month. “To reach an agreement with ETA is to humiliate the living and the dead,” said the head of the association representing the victims, Francisco Alcaraz. The future of the 2000 anti-terrorist pact, signed by both main political parties, which has contributed to ETA's present fragility, may now be in doubt.

Although this is the first time a government has sought approval from the Cortes, previous governments have in fact talked to ETA. The Socialist government of Felipe González did so in 1989, as did Mr Aznar in 1999, before ETA ended its 14-month ceasefire, causing him to round on all regional nationalists. Neither lot of talks ended the 30-year conflict that has killed more than 800 people. Almost two-thirds of Spaniards support the opening of talks between Madrid and ETA, if it renounces violence, says a poll by the Opina institute. Mr Zapatero argues that ETA has been weakened by numerous arrests and has not staged a fatal attack in two years, making this a good moment for a peace process.

Arnaldo Otegi, leader of ETA's banned political wing, Batasuna, has recently made vague overtures for peace. Most Basque political parties, still wrangling over forming a regional government after last month's elections, talk also of the existence of favourable conditions for peace. Mr Otegi has said that the Cortes's motion could lead to “a Basque Stormont” (after Ulster's parliament), but that Basques must decide their own future. Mr Zapatero has argued, unconvincingly, that there will be no political price to pay for talks. Officials insist that they have little to offer ETA beyond improving conditions for the several hundred prisoners from the group who are in Spanish and French jails.

A development that boded ill for Mr Zapatero's hopes was the explosion of four small bombs near Basque businesses last weekend. The bombs are thought to have followed non-payment of ETA's extortion money, known as revolutionary tax. Unusually, in a speech some hours later, Mr Zapatero failed to mention the bombings. Angel Acebes, a senior PP member, called the omission “disgraceful”.

The newspaper *El País* called the talks proposal “a high-risk political initiative”. Javier Pradera, a columnist, argued gloomily that ETA's “opaque decision-making...and irrationality” could mean that it tricks its interlocutors and plays for time. “It would be improbable that an organisation like ETA would be ready to abandon violence without a political price,” he wrote. Yet one top Socialist is confident. Referring to Northern Ireland, he says, “Look at the Good Friday Agreement. It has been a long process. There was even Omagh [a lethal IRA bombing] to contend with.”

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Italian politics

Back from the dead?

May 19th 2005 | ROME
From The Economist print edition

An election win, but Silvio Berlusconi is still in political trouble

Get article background

Reuters

Medical help much needed

RARELY can a politician have had such cause to thank his doctor. Umberto Scapagnini, one of several doctors who attend Italy's prime minister, Silvio Berlusconi, scored a remarkable win in Catania this week when he was re-elected mayor. Catania is the biggest of 38 towns in Sicily where elections were held. Three days before the vote, Mr Scapagnini and other pro-government candidates were dealt a huge blow when news emerged that Italy was in recession for the second time in two years. Italy's poor performance was all the more striking because German GDP posted its biggest quarterly rise in four years.

The Italian media promptly decided that the poll in Catania was a test that could decide Mr Berlusconi's fate. Mr Scapagnini was personally linked to the prime minister, who spent two days campaigning in the city. That just made the eventual victory all the sweeter. Mr Berlusconi may now have enough authority to end squabbling among his allies and struggle through to the end of the parliamentary term next spring.

Yet he is still wounded and limping. Few Italians may fret over the stream of corruption allegations levelled at him, or over the clash of interests between his roles as businessman and politician. But they certainly care about money. Indeed, the reason they handed power to Mr Berlusconi four years ago was that he convinced them he could use his entrepreneurial genius to revive the economy.

Now, with just one year to go before the election, his government has cut its growth forecast for the second time in a month. The finance minister, Domenico Siniscalco, says he is looking for only 0.6%, and does not rule out zero. Since 2001, Italy has slipped to become the least competitive country in the euro area; it comes 47th in a global ranking compiled by the World Economic Forum.

One reason for this poor record is that desperately needed reforms have only recently been begun. Mr Berlusconi's government devoted much of the first half of its five-year term to legislation to favour his personal or business interests. It has since invested huge amounts of parliamentary time in a constitutional reform of dubious necessity, to satisfy the Northern League. By contrast, Germany's Chancellor Gerhard Schröder was lining up reforms, albeit timid ones, over two years ago.

The other reason for Italy's waning competitiveness is that the country remains so hostile to liberalisation. It is still protectionist, socially conservative, hostile to meritocracy and ridden with cronyism, tolerant of corruption, prey to organised crime and hamstrung by informal, invisible cartels. A look at any recent figures shows just how dire the situation has become. According to the World Bank, it takes $3,796 and 13 days to set up a business in Italy, compared with $306 and eight days in France, hardly a bastion of free-market thinking. An international study has found that bank charges for the average Italian account-holder are the highest in Europe. For what it is worth, Italy has proportionately fewer researchers than Portugal, and half as many graduates between the ages of 25 and 34 as Greece. It will take more than Mr Berlusconi's removal to put right such deep-seated woes.

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Serbian justice

On trial

May 19th 2005 | BELGRADE
From The Economist print edition

A lively start for a new organised-crime court

Get article background

ASSAULTS are not meant to happen in court. Yet Aleksandra Ivanovic, the wife of a man on trial for murdering Zoran Djindjic, Serbia's prime minister, in 2003, managed one when she hit a prosecution witness on the head with her handbag. He had called her husband “a biological insult”; as she struck him, she shrieked, “it's you that is the biological insult!”

Such scenes might suggest that Serbia's special court for organised crime and war crimes is a joke. Yet to the surprise of many, it has made steady progress in Serbia's war on organised crime. It may even soon win its first case sent back to Serbia by the UN war-crimes tribunal in The Hague. (This week, the tribunal sent a first case back to Bosnia for trial.)

The court was set up just before Djindjic's assassination in March 2003. He was murdered on the eve of unleashing a police operation to crush organised crime. The court was part of that strategy; now one of its first high-profile cases is of the men accused of killing him. So far it has begun 34 organised-crimes trials. Eight have reached a verdict and ten are close to one. Besides the Djindjic case there are several others involving political murders or attempted murders.

In the Djindjic trial the prosecution is trying to show that Milorad “Legija” Ulemek, Ms Ivanovic's husband and former head of the police's notorious special operations unit, organised the death of Djindjic before he could crack down on crime bosses, especially the Zemun Gang. The defence is trying to show that Djindjic and his associates had a suspiciously close relationship with the gang.

Milos Vasic, a Belgrade journalist and author of a best-selling book on the Djindjic killing, says he has been impressed by the court. “Slow but pretty thorough,” is his verdict. Maja Kovacevic Tomic, the court's spokesman, is even happier. She notes that, when Vojislav Kostunica became Serbia's prime minister in March 2004, his government promised to close the court. Now, as it chalks up successes in the war on organised crime, the government has backed off from that threat. So a forum remains in which witnesses are claiming that Mr Kostunica and his allies helped to set the stage for the murder of Djindjic, his arch-rival.

Mr Kostunica may have decided to ignore this because he has his eye on what could prove to be a bigger prize. He has always argued that, if Serbs committed war crimes, they should be tried at home, not in The Hague. There is one war-crimes trial at the special court, of a group accused of taking part in a massacre of Croatian prisoners from Vukovar in 1991.

At the Hague tribunal judges are now examining cases of lesser ranking indictees to see whether they can be tried back home. Last week they began to consider whether the case of three Serbs, alleged to have organised the Vukovar massacre, should be returned to Belgrade. Croatia also wants this trial, because the killings took place on its soil.

If the judges opt for Belgrade Mr Kostunica will take the credit. He will see it as a reward for sending 15 indictees to The Hague since October. More important still, it might give him political cover to do the unthinkable: to order the arrest of the two big fish still at large, General Ratko Mladic and Radovan Karadzic (if either is in Serbia). The Hague tribunal has indicted both men on genocide charges.

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Charlemagne

Putting the clog in

May 19th 2005
From The Economist print edition

Why Dutch voters may upset the European constitution

FOR months European leaders have been transfixed by the fear that the French may say no to the European Union's constitutional treaty. But they may have been looking in the wrong direction. For the opinion polls suggest that the biggest threat to the constitution will not be the French vote on May 29th, but the Dutch referendum three days later, on June 1st.

French opinion polls are neck and neck, with a slight tilt back to no this week; but the bookmakers still make the yes campaign the favourite to win. In the Netherlands, by contrast, the most recent poll by Maurice de Hond, the country's leading pollster, has the no campaign ahead by 55% to 45%. Mr De Hond says that, unless the debate changes radically in the next couple of weeks, “I'm very confident it will be a no.” For the first time, the Dutch government's own polls are also showing the no campaign ahead, albeit only by one point.

Since all 25 members of the EU have to ratify the constitution for it to come into force, a Dutch “nee” would have just as much legal significance as a French “non”. It is true that, politically, France matters more: it is a bigger country and its statesmen played the central role in getting the European project going in the first place. But the importance of the Netherlands to the EU—and therefore the significance of a Dutch no to the constitution—should not be underplayed. Like the French, the Dutch were among the six founders of the European Economic Community in the 1950s. The treaty that led to a single currency for Europe was signed in Maastricht; a later treaty was signed in Amsterdam. The first head of the European Central Bank was Dutch. With a population of 16m, the Netherlands cannot be dismissed as a tiny country. It has also traditionally been solidly pro-European, with no equivalent of the French Gaullist tradition. On this basis, a Dutch rejection of the EU constitution would in some ways be even more shocking than a French one.

The themes of the Dutch and French campaigns have been wholly different. French complaints that the EU has been hijacked by “ultra-liberal” economic reformers find little echo in the Netherlands. Instead Dutch Eurosceptics sound more like their British counterparts, giving warnings that their country may be turned into a province of a European superstate.

Yet there is one broad similarity between the Dutch and French campaigns. In both countries, the no side is feeding off a powerful anti-establishment sentiment. In the Netherlands, all the main political parties, representing 85% of parliamentarians, are in favour of a yes. So are the employers' association, the trade unions and almost all newspapers. Yet this elite consensus may actually be proving counter-productive. Ever since Pim Fortuyn, a populist anti-immigration politician who was later assassinated, burst on to the scene in 2002, the scope for running against the Dutch establishment has been obvious. Michiel van Hulten, co-ordinator of the independent yes campaign, frets that the referendum is turning into a “confrontation between the political elite and the Dutch population”.

The no campaign is about a lot more than incoherent resentment of the ruling class, however. The Dutch also have solid reasons for being disgruntled with the EU. On a per head basis, they are the largest net contributors to the EU budget, which is clearly unfair, given that the Netherlands is by no means the richest member. The replacement of the Dutch guilder by the euro is also widely believed to have caused inflation. Only 39% of Dutch people reckon their new currency has been a success, a higher level of unhappiness than in any other euro member. Disillusionment has been fed by the fact that the Dutch government fought hard for a strict interpretation of the rules on budget deficits in the euro area, only to be overruled by France and Germany. The no campaign points out that the same elite that signed up to the euro and allowed mass immigration with little public discussion is now lining up behind the EU constitution. “People say that too many important changes have been made without real debate”,

concedes Atzo Nicolai, the government's Europe minister, “and they are right about that.”

Scare stories in the low countries

Faced with a referendum campaign that is threatening to go badly wrong, the Dutch government's reaction has been simultaneously shrill and lackadaisical. The economics minister has declared that a rejection of the constitution would mean that “in the long run, the lights will go out and we will lock our country out of Europe.” The justice minister has suggested that western Europe could even slide into Balkan-style wars. Jan Peter Balkenende, the Dutch prime minister, said that a visit to Auschwitz had brought home to him the importance of supporting European integration.

If the possible consequences of a Dutch no vote really included economic collapse, war and genocide, it seems a bit casual of Mr Balkenende to head off to Malta just three weeks before the vote. Aware that dire warnings of catastrophe have been greeted with a mixture of scorn and irritation, the government has now sworn off these scare tactics. Instead, the yes campaigners are using the closing weeks of the campaign to portray the constitution as a modest document (“not even a real constitution”, they say) that is beneficial, but not that radical.

It remains quite possible that a country with such a strong history of commitment to the European cause will in the end back the constitution. But in case of rejection in either France or the Netherlands, pro-constitution forces will be ready with excuses. The French, it will be said, were really voting about high unemployment and their dislike of Jacques Chirac. As for the Dutch, they are still in the grip of the national angst unleashed by Fortuyn. A double rejection, however, would raise a more disquieting thought: that the problem was not the French or Dutch electorates, but the constitution itself.

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Oxford University

The vice-chancellor's punt

May 19th 2005
From The Economist print edition

Britain's oldest university wrestles with modernisation

Get article background

IF YOU were starting to build a world-class university from scratch, you probably would not choose Oxford as your model. The university is essentially a collection of medieval monasteries run like a workers' co-operative. It includes 39 colleges of wildly different size, wealth and quality. Each operates independently, sometimes extravagantly so. Most dons, as Oxford and Cambridge academics are called, are paid partly by colleges and partly by the university. Colleges and academic departments work in parallel. Management is by committee. Ultimate power rests with a dons' parliament, the 3,552-member Congregation.

Picturesque relics of English history are more fun to observe than to run, as John Hood, who took over in October as Oxford's vice-chancellor, has discovered. Decision-making at Oxford is piecemeal and takes ages. Although some teaching and research is awesomely good, quite a lot isn't. Some of the colleges are massively rich, some virtually bankrupt.

Oxford is still the fifth-best university in the world, according to one recent study, and the eighth according to another, but Mr Hood believes that unless the way it is managed changes, it will slide down the rankings. The government has also been urging Oxford (and Cambridge, which has a similar structure) to modernise.

Mr Hood's two big proposals have each sparked big rows. The first is to centralise decision-making. A board of external trustees would set the university's overall budget; under them would be a single management body in which the heads of colleges would be in a minority.

The second is to change the way in which dons' work is managed. The colleges, which do most of the teaching, assess their dons one way. Departments, where most of the research happens, have another. Both systems are informal and patchy. Good results rarely mean higher pay, nor do bad ones tend to hurt. Mr Hood wants to link pay and performance.

Outside Oxford, these changes might seem mild and sensible, but things look different from inside the university. Opposition to Mr Hood's first proposal has been huge. It is now being reworked, and a new version will be discussed again in November. The second proposal, on performance review, has fared worse. Congregation voted it down this week.

In part, Mr Hood's critics don't like the way he has gone about his reforms. He was, they say, hurried, secretive and clumsy. “He talks of consulting Congregation. He doesn't realise that he has to ask it for permission,” says one head of a college. That criticism may be blunted by the new round of delays and discussions.

It's personal, too. A brisk New Zealander, Mr Hood has little time for self-indulgent eccentricities. Many dons think he's insufficiently respectful of Oxford's age and grandeur. “It's not as if we've been sitting around wishing we were as good as the University of Auckland. It's not as if he were from Harvard,” sniffs another college head. Mr Hood has appointed a former colleague from New Zealand to a top job, prompting cries of cronyism (a vice previously unknown in Oxford).

Also, however, dons fear that the vice-chancellor's proposals threaten the very thing that makes Oxford special: undergraduate teaching in tutorials between one don and two students. That's centred on colleges: Mr Hood's critics fear that weakening their power would turn them into dormitories,

undermining the personal nature of an Oxford education.

Yet the real issue is that many dons think making Oxford's management more businesslike is the wrong kind of change—“an outmoded and neo-Luddite corporate mindset based on US-style managerialism” in the words of one leaflet published this week. Tight budgets and clear objectives are all very well if you are trying to make money, they say, but thinking great thoughts and sharing them with the young is a different business. The level of supervision needed to root out all the mediocre will also stultify the brilliant. The collegiate system may look messy, but it guarantees diversity and experiment. When most dons are ill-paid, giving high salaries to a few newcomers will damage morale without raising standards. The real challenge, they say, is not fiddling with structures, but raising enough money to free Oxford from state control.

Fundamentally, such critics want a university in which the dons are the owners, not hired staff. Jo Quinn, a young classicist who helped organise this week's revolt, moved from Berkeley in California, a famously socialist place, because she liked Oxford's “amazing democratic system”.

Mr Hood's supporters think the threat to Oxford's ethos is preposterously exaggerated. One college head says there has been a “fog of disinformation” about the proposals. A clearer, simpler system would spread power and make Oxford more democratic, he argues. Most universities, he notes, have a majority of outsiders on their governing body. Why should Oxford be different?

The big question now is how hard Mr Hood wants to push on. Recent setbacks do not reflect the real balance of power. Many college heads, while unhappy about some of the specifics, are not against the main thrust of reform. Alan Ryan, the warden of New College (so named because it was founded as recently as 1379) says that the university should set “the financial climate for the colleges, and let them get on with it”. Though dissident dons can easily outvote the university bosses in a meeting of Congregation, in a postal vote among all its members the likely outcome is the other way round, especially if Mr Hood tweaks his changes to make them seem a choice between stagnation and revival.

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Oxford's libraries

Booked out

May 19th 2005
From The Economist print edition

The Bodleian Library is old, lovely and inefficient

Get article background

OXFORD'S library, the Bodleian, is the oldest in Britain, and occupies some of the city's most beautiful buildings. It has a noble motto: Thomas Bodley, its benefactor, said it should belong not just to the university, but to the “republic of letters”. But it is also cramped and cash-strapped.

The people who run it are therefore trying to cut costs and use space more sensibly. That means rationalising the university's network of libraries, which include separate ones for each academic faculty and for each of the 39 colleges. They are also, to the fury of some dons, trying to raise money by using the libraries as corporate entertainment venues.

At the centre of the row is the Radcliffe Camera, probably Oxford's best-known building, which houses a small part of the Bodleian's humanities collection. Books have to be brought from the main shelves along a lengthy and unreliable underground conveyor belt.

Many of those who use the library believe that where thinking and reading in it are concerned, a building's beauty outweighs its impracticality, but administrators think the Radcliffe Camera is too small and inconvenient to be useful. A meeting of the library executive in January considered making it into a “central public relations display space”. The university says it has no plans to take the building out of academic use. But suspicions remain that it may end up as a gift shop: the university currently lacks any central location to extract money from the city's millions of tourists.

The most pressing worry is space. The university, which gets a free copy of every copyright text published in Britain, is running out of shelf space in its main storage location. The central stacks, deep underground, are below the water-table. The plan is to empty many of them, use the storage for university archives and move most of the books to two big new sites, one in the disused university hospital, the other on an industrial estate.

As with the wider questions of university reform, however, the big issue is centralisation. Dons want the central library backed up by multiple specialist collections, preferably nearby, with open shelves, relaxed borrowing rules and a knowledgeable librarian. Administrators want one big library run by robots and computers. If you want a book, you order it online, wait until it's delivered, read it in a modern, purpose-built, properly lit, secure, well-ventilated modern library with proper access for disabled people and then return it.

That's a dilemma for the university. User-friendly libraries, like beautiful surroundings, are one of the ways in which Oxford makes up for the miserable salaries it pays its dons.

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Working hours

Slacking off

May 19th 2005
From The Economist print edition

Britons are moving towards European working habits

GORDON BROWN, the chancellor of the exchequer, promised businessmen on May 17th that a “more humble” government would lighten the burden of regulation. Employers remain to be convinced. For one thing, Labour is planning to introduce new rights for workers such as longer paid maternity leave. More pressing is the looming threat that Britain may lose its opt-out from the 48-hour maximum working week in the European Union.

This exemption from the EU working-time directive allows individuals to work longer than the 48-hour maximum if they choose to. Among the 15 countries of the EU before last year's expansion only Britain has exercised the opt-out. Among the ten member states that joined the EU last year, most chose not to apply it.

Last September, the European Commission proposed reforms to the working-time directive that left the opt-out intact. But on May 11th the European Parliament voted to abolish it. British employers, and Tony Blair, want to keep it. The Council of Ministers will meet next month to discuss the matter.

Mr Blair's stance has infuriated trade unionists, who claim that British workers are in thrall to a “long-hours culture”. Yet only a small minority regularly works more than 48 hours a week. According to the Office for National Statistics, 3.26m employees—13% of the total number including part-timers—work such hours. Of these, 2.53m are men, representing 23% of male full-timers, and 730,000 are women, representing 11% of female full-timers.

But aren't British workers the Stakhanovites of Europe? Not really. True, full-time employees, along with those in Latvia, work the longest hours in the 25 countries of the EU. But the gap between Britain and other countries is quite small. In 2004, the usual working week (which does not include the effect of time off on holiday) averaged 42.8 hours, compared with 40.3 in the EU and 39.7 in the 12-country euro area. If the self-employed are included, Britain slips behind Greece and Austria.

Furthermore, a much bigger proportion of workers—exceeded only in the Netherlands—work part-time in Britain. According to Eurostat, 26.2% of British workers were part-timers in 2004, compared with an average of 17.8% in the EU.

Looking at all workers, part-time and full-time, and taking into account holidays, Britain no longer heads the European league table. According to the OECD, British workers actually worked an average of 1,673 annual hours (32 hours a week) in 2003. While generally higher than in the euro area, the figure was lower than in four member states—Greece, Spain, Portugal and Finland. It was also lower than in America, Australia and Japan, where workers each put in around 1,800 hours a year on average.

What's more, British workers are moving away from American habits towards European ones. Average working hours in Britain have been falling over the past few years (see chart). Official figures released this week show that, including time off on holiday, full-time workers worked an average of 37.3 hours per week in the first quarter of 2005. That's 1.4 hours fewer than at the start of 1997.

Over the same period, part-timers have increased their working week by half an hour and female full-timers have cut theirs by half an hour. The decline has been concentrated among men working very long hours. In early 1997, 39% of male workers regularly worked over 45 hours a week; that's now down to 31%. Over the same period, the proportion working 31-45 hours has risen by six percentage points.

Some of the fall in working hours may have been caused by the EU directive, which came into force in Britain in October 1998. But the decline started long before then. In 1850, workers on average slogged away for around twice as many hours a week as they do now, and working time has fallen steadily since. Furthermore, the self-employed, who are not affected by the directive, have cut long hours to an even greater extent than employees.

Irrespective of EU rules, Britons are working less because they value their time off. But workers have been choosing to make this trade-off, rather than having it imposed on them by bureaucrats.

One-size-fits-all European rules have a bigger impact in Britain because the pattern of working times is much more diverse than in the rest of Europe. This is the main reason why Britain's government should do its best to keep the opt-out.

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The politics of behaviour

R-e-s-p-e-c-t

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A new worry, and a new political buzzword

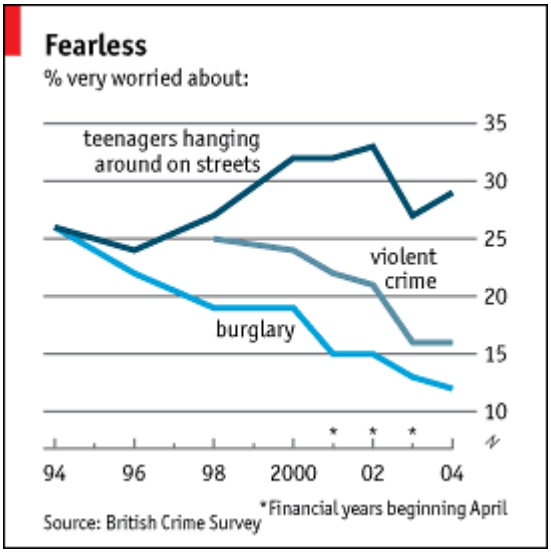
IN A press conference on May 12th, Tony Blair acknowledged there was too little of it. Five days later, the queen announced that the government would try to foster it. Respect, and its gradual disappearance from British life, is something that Labour MPs heard a lot about while canvassing voters in the general election campaign. John Prescott, the deputy prime minister, found out about the decline of modern society more directly, thanks to some “fellas with hoods on” who, he claimed, had tried to menace him in a motorway café.

Britons were fretting about the decline in civility two decades ago, when muggers and heroin addicts roamed the streets. They were equally pessimistic four decades ago, when mods and rockers scuffled in seaside towns. And so on, in an unbroken chain of anxiety reaching at least to 1843, when Lord Ashley told the House of Commons that “the morals of the children are tenfold worse than formerly.”

Geoffrey Pearson, who follows popular fears at Goldsmith's College in London, says history may be responsible for the persistent British belief in slipping standards of conduct. It is easier to believe in an eternally tranquil past if your nation was not forged in rebellion, as were France and America, for example. But there is a particularly good reason for British politicians to declare war on disrespect and hooded tops at the moment: scarier things are disappearing.

In the past ten years, incidents of what the police call “volume crime” have become rarer. Burglary and car crime are about half as common as they used to be, while robbery has fallen by a fifth. Fear of such crimes has diminished, too, despite the best efforts of the media (see chart).

Instead of calming down, though, the public seems to have become more troubled by comparatively minor menaces. More people see loitering teenagers as a problem these days, which is odd, given that fewer are worried about the malign things with which they are often associated. It may be that levels of anxiety do not change much: as one source of worry fades, another takes its place.



Concerns about anti-social behaviour are more widespread than anxieties about crime. According to the British Crime Survey, just 10% of men worry about violent crime, compared with 29% of women (they have got it the wrong way round: men are much more likely to be victims). But equal numbers of women

and men believe anti-social behaviour to be a big problem in their area. That means a politician who makes a fuss about disrespect is guaranteed a broader audience than one who bangs on about the hazards of walking the streets after dark, as the Tories did during the election campaign.

Making Britons more respectful will be difficult. It is one thing to tackle bad behaviour in a closed environment such as a football stadium (where arrests per fan have halved since the early 1990s); it is another to tackle disorder in the streets. Changing attitudes is harder still. Despite a large increase in the use of anti-social behaviour orders between 2003 and 2004, the proportion of people saying anti-social behaviour was a problem in their area did not change.

But the government has made a good start by picking the right word on which to campaign. There are few values rated as highly by hooded thugs as by the decent citizens who fear them. “Respect” is one.

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Royal Mail

Delivering results

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From The Economist print edition

The revival of the Royal Mail

THREE years ago, Britain's government-owned postal monopoly was a mess. Under pressure from rising wages, a junk-mail downturn and the cumulative effects of 35 years of state ownership, Royal Mail was missing its delivery targets and losing £318m a year. A new management team was brought in to sort it out. Allan Leighton, a former boss of Asda, a supermarket, was appointed chairman, and Adam Crozier, a former head of the Football Association, became chief executive. They hacked £1.5 billion of costs out of the business, sacking 33,000 staff, closing 2,500 branches and reducing deliveries to one per day instead of two. Stamp prices were raised, boosting revenues.

Financially at least, that strategy seems to have paid off. On May 17th, Royal Mail announced profits of £537m on record revenues of £8.96 billion. Meeting his profitability targets earned Mr Crozier a £1.8m bonus, as well as providing bonuses of £1,074 for each for the firm's workers. Critics complained that the company was still not meeting its annual delivery targets, although the firm says it met half of them in the final quarter.

Still, it is not terribly surprising that big profits are possible with a government-sanctioned monopoly. Currently, only 30% of Britain's postal market is exposed to competition. The government had planned to introduce full competition by 2007, but Royal Mail's new-found profitability has so impressed Postcomm, the industry regulator, that it has decided to move the date forward to January 2006.

How much of an impact that will have is uncertain. If foreign experience is any guide, not much will change. The Swedish market was liberalised in 1993, but ten years later Sweden Post, the old state-owned monopoly, was still delivering 94% of the post. New Zealand Post lost its monopoly in 1998, but after five years still controlled 98% of the market. Royal Mail's giant distribution network, which reaches every household in the country, will give it a powerful advantage over its rivals, since big firms that write frequently to their customers—banks, say, or utility companies—will be able to use a single firm for all their deliveries. Competitors could offer to pay Royal Mail to use bits of its network—one company, UK Mail, has already done so—but owning the infrastructure will make Royal Mail the dominant partner.

But Royal Mail itself argues that things will be different in Britain. “We probably won't be allowed to price as aggressively as the Swedes,” says a spokesman. Most of its revenues come from a few large business customers, and losing even some of those could put a big dent in its profits. Paul Jackson of Triangle, a consultancy, reckons that Royal Mail will lose 10-20% of its market share—and a big chunk of its profitability—over the next five years, although he also says that, if it can improve flexibility and efficiency, its long-term future is probably secure.

Mr Leighton has already suggested one way to boost efficiency. He wants to partially privatise the company by buying 51% from the government and holding the shares in an employees' trust. Giving workers a stake in a company is a textbook motivational technique, but there may be problems. The Labour Party said in its election manifesto that it wanted to see “a publicly owned Royal Mail fully restored to good health”, which would seem to argue against privatisation. But the government is expected to begin a review into Royal Mail in the next few months, and the manifesto's wording leaves plenty of wriggle room. Fittingly, the final decision will be taken by one of Royal Mail's own: Alan Johnson, the minister in charge, was a postie before he was an MP.

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Regional newspapers

The Cinderella of print

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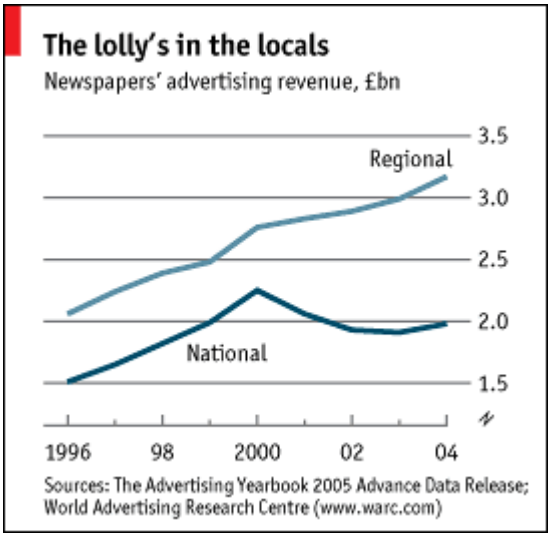
Nationals have all the prestige, but regional newspapers are flourishing



THERE has never been so much gloom about the future of newspapers. Conventional wisdom holds that they are on their way out as young people switch to the internet for news, and the only question is how quickly it will happen. But one variety of newspaper is in good health. The hundreds of chronicles, gazettes, posts and recorders that report on Britain's regions are attracting more advertising and readers than ever. Their future seems bright, and they are proving themselves to be better than big national papers at coping with the internet.

Advertising in local papers has risen in each of the past ten years at an average annual rate of 5.4%. At nationals, ad revenue fell for three years after 2000 and did not start to recover until last year. More people read locals: 85% of the population read them in 2004 versus 70% for nationals, and the gap is widening. Regional papers' profit margins are much higher than those of nationals, mainly because they have near-monopolies in advertising in their areas. Tweedy Browne, a shareholder in Trinity Mirror, Britain's biggest regional newspaper company, has advised the firm to sell its five national papers and concentrate on its local ones. Trinity Mirror says it's not under any pressure from its shareholders to do so.

So far, regional papers have not seen classified advertising disappear off to the internet as nationals have. That's mostly because the ads are so local. But regional papers are doing plenty to combat the threat from the internet. Print ads are replicated on their websites. In 2000 four regional groups jointly launched their own online classified site for recruitment, homes and cars, called Fish4. It is now Britain's most-visited paid-for job site.

Trinity Mirror is to start charging readers for a digital edition of its *Newcastle-upon-Tyne Journal*, and if that works will do the same at its other titles. Whereas the content of most national papers is too general to get people to pay for it on the internet, local news should be sufficiently specialised to attract subscribers online.

Regional papers are also willing to experiment with new means of distribution. The *Yorkshire Evening Post* in Leeds, for example, is sold in Ikea, a furniture store, and its editor, Neil Hodgkinson, says the company is thinking of putting it in off-licences and Chinese take-aways.

Local titles do share one problem with nationals, which is that circulation of daily editions is falling gradually. But the decline of the regionals' circulations is not as steep as at national papers. At weeklies, meanwhile, circulation has increased slightly over the past five years.

The secret of keeping readers appears to be to focus ever more tightly on local news. Johnston Press, which owns 244 regional papers, found from research that what its readers want is even more local reporting and less of what does not touch them directly. The *Barnsley Chronicle,* a family-owned paper, has expanded circulation by a fifth since 1994 by launching editions for individual villages. “If an atom bomb fell a mile outside the Barnsley area, we would not report it,” says its editor proudly, and the paper carried nothing at all about the general election.

Plenty of bigger metropolitan regionals do report on national politics—as well as on matters such as crime-busting milkmen and the evils of chewing gum. What they write has credibility with readers because few have allegiance to a political party. Regional bosses realise that slanted reporting is bad for business as it alienates a slice of the audience. Politicians like talking to local papers, says David Hill, the prime minister's media spokesman, because they have pride in their region and are more willing than national papers to acknowledge when the government has a positive local impact.

It isn't commercial competition that troubles regional newspaper companies. What they are really scared of is the BBC. As part of winning another ten years of public funding the BBC has promised to make highly localised television. “If the BBC stomps its big feet into local television, radio and websites, that is competing with us for audience,” says Ian Davies, director of business development at Archant, a regional newspaper publisher in Norwich. The government will be hearing about this from regional press bosses this year. It would be ironic if, in its drive to serve local markets better, the BBC inadvertently damaged the bit of the newspaper market that is doing just that.

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The Tory leadership

The generation game

May 19th 2005
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Despite Michael Howard's best efforts, it still looks like David Davis

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IN THE immediate aftermath of another bleak election result for the Tories, Michael Howard, the Conservative Party leader, signalled that he would do his party one last, important service. Rather than quit immediately, he would stay on long enough to put in place a new system of electing a leader. In the five months before that could happen, the contenders would have the chance both to debate the future direction of the party and to show whether they were up to the job.

But many suspect that was not quite all Mr Howard intended—that he was also hoping to deny the top job to the bookies' favourite, David Davis, the shadow home secretary, while advancing the cause of two young favourites, David Cameron and George Osborne. Mr Howard hoped to achieve his first objective by restoring to the party's MPs the sole power to elect the leader. Mr Davis, much-admired by party activists for his battered good looks, humble origins and robustly right-wing views, has acquired a reputation among his fellow MPs for disloyalty. By making Mr Cameron (38) shadow education secretary and Mr Osborne (33) shadow chancellor, Mr Howard appeared to be suggesting that the party should skip a generation and pick one or other of those two bright young things to succeed him.

But Mr Howard's efforts on his protégés' behalf may have been counter-productive. Although an election under the new rules cannot take place until November, Mr Cameron and Mr Osborne, who are posh as well as youthful, are already the object of much spiteful comment from their colleagues. One senior MP observed: “On top of our usual disagreements we are now riven with ageism and class hatred.” Another says: “Just because they're metropolitan and have gay friends, Michael thinks they're the future.” Should Mr Osborne, who, it must be said, is bright and personable, be crushed beneath Gordon Brown's tank tracks, there will be much glee on the benches behind him.

By so blatantly favouring Mr Cameron and Mr Osborne, Mr Howard has infuriated capable and experienced fortysomethings, such as Andrew Lansley, David Willetts and Damian Green. Though their own hopes of emerging as contenders may be slim, they are the kind of people who any prospective leader will need to woo and win over. The same goes for the even more ancient Sir Malcolm Rifkind and Tim Yeo.

Having whipped up resentment and jealousy, Mr Howard's hopes of stimulating a serious discussion about what the party needs to do to make itself electable are unlikely to be realised. Potential candidates declare their modernising credentials by turning up tieless in television studios where they spout wearingly familiar slogans about change and the need to reconnect with the voters. But, so far, it is all woefully vague and short on specifics.

Meanwhile, Mr Davis increasingly has the look of a man who believes the prize is his to lose. After three election defeats, the Tories may finally have learned at least one thing: it is sensible to pick the leader who has the greatest appeal to the widest number of voters. And Mr Davis, the son of a single mother who grew up on a council estate, is serenely confident that he fits that bill. In interviews he tends to say little about how he would lead the party, and a lot about himself.

Ironically, the greatest threat he may face is not from either of the young guns, but from Kenneth Clarke, who is a year older than Mr Howard. Opinion polls still suggest that Mr Clarke, who will be nudging 70 at the time of the next election, is the person most people would like to see lead the Tories. Mischievously, Mr Clarke, although twice rejected by his party, has not ruled out standing.

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Bagehot

Desperate for a legacy

May 19th 2005
From The Economist print edition

A hyperactive legislative programme will not secure Tony Blair's place in history

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WITH its promise of nearly 50 bills to be brought before Parliament over the next 18 months, this week's Queen's Speech was billed as a determined attempt by Tony Blair to demonstrate that the loss of his towering majority has done nothing to sap the government's vigour. The programme, said Mr Blair, was “quintessentially New Labour”. But to many of the MPs listening, the frenzy of legislative activity spoke more of a prime minister who is desperate to secure his legacy, but who knows his time is running out.

Ever since Mr Blair won his third election victory, the talk has been of when he would stand down and how much in his newly straitened circumstances he could get done before he went. Each proposed bill is being carefully inspected for its prospects of surviving the expected rebellions by dissident Labour MPs, any one of which could bring the prime minister crashing down. Those impatient for Mr Blair to go compare his loss of authority to that of John Major after the pound's ejection from Europe's currency system, when he was said to be “in office, but not in power”.

Mostly, this is froth. Not only is the government in a stronger position to carry through its business than is generally appreciated, but also relatively little of what Mr Blair regards as his legacy hangs on the legislative programme.

There are several reasons why the danger of wrecking rebellions has been exaggerated. The first is that nearly all the proposed legislation was explicitly foreshadowed in Labour's manifesto and in the departmental five-year plans drawn up by ministers before the election. In the last parliament, the three biggest rebellions were over Iraq, university tuition fees and foundation hospitals. Understandably, there was no commitment to invade Iraq in the 2001 manifesto, but the same document, in the passage on NHS reforms, made no mention of giving some hospitals more autonomy, while top-up fees were specifically ruled out. The failure to prepare the ground made the whips' task far more difficult than it need have been.

Second, despite some posturing, there are signs that the government is taking a more consultative approach than previously. Ministers not known for their emollience, such as Charles Clarke, the home secretary, and David Blunkett, restored to the cabinet as work and pensions secretary, are promising to listen carefully to the views of backbenchers before legislating to introduce identity cards and reform incapacity benefit.

Third, Gordon Brown is likely to abandon the rebels. During Labour's second term, his tacit support for opposition to foundation hospitals and tuition fees gave the rebellions a respectability they would not otherwise have had. But his agenda has changed. He no longer wants to destabilise Mr Blair: instead, his aim is to ensure that he inherits a disciplined and united party. There are a few substantive issues on which they disagree—on foundation hospitals' freedom to borrow, for instance—and which may yet cause spats between them. But Mr Brown has no interest in pandering to Old Labour prejudices. All he wants is to make sure that he wins the next election.

Even if Mr Blair does end up making some painful concessions to get some of his legislation through, he can probably live with it. It is not whether we are all carrying ID cards in ten years' time but the improvement in public services—above all, schools and health care—that will decide if he is seen as a prime minister who made a difference to more than just his party's capacity for winning elections.

There is some legislative tidying-up to be done as far as schools are concerned: parents are to get a

number of new rights; primary schools will join secondaries in being allowed to escape local authority control; it will become a bit easier to set up new, independent schools paid for by the taxpayer. But, for the most part, further progress depends on executing existing policies and not passing new laws. Revealingly, the only health legislation on the stocks provides for a cautious extension of smoking bans in public places and a “hygiene code” for hospitals infested with the superbugs whose presence in hospitals has become a national fixation. The lack of anything new or controversial is a sign that the government is convinced that what's already in place is working.

Too soon to tell

Does this mean that Mr Blair's legacy is safe after all? If that means a modernised, but still overwhelmingly tax-funded, welfare state that delivers services good enough for middle-class consumers to use and support, it is too early to say. For all the huffing and puffing against choice and consumerism on the left of the party, that's not where the danger to Mr Blair's legacy lies.

Mr Blair can point to thousands of additional doctors and nurses, reduced waiting lists, graduates who are once again eager to become teachers, new school and hospital buildings mushrooming across the country. Not all, but most, of this has been achieved with money and lots of it. With the economy slowing, and spending in three years' time set only to keep pace with growth, that can't continue. The swing to the Tories in the south-east and the prosperous London suburbs carried a warning of mounting resistance to higher taxes. Further improvements will depend on innovation and efficiency, spurred by market disciplines. That will require persistence, political courage—and time, the commodity Mr Blair is shortest of.

It took the best part of a decade before the full impact of Margaret Thatcher's economic reforms was felt. Because Mr Blair took a while to get into his stride, his public-service reforms are still very recent and only now gaining some momentum. Frustratingly for him, he is likely to be long gone from office before he really knows whether he has a legacy that is any kind of match for Lady Thatcher's.

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Open wider

May 19th 2005
From The Economist print edition

Uneven regulation and protectionist practices are holding back international competition in banking. David Shirreff (interviewed here) explains why banks are considered special, but need to become less so

PASSAU, a small German town near the Austrian border, may seem an unlikely place for a skirmish in the campaign for European banking integration, but that did not stop local German banks last year from complaining loudly that Austrian bankers were stealing their business because of lighter Austrian regulation. Jochen Sanio, head of Germany's financial watchdog, BaFin, duly wrote to his Austrian counterpart, Heinrich Traumüller, demanding that the Austrian rules be tightened. The main issue was the lending threshold above which banks have to produce a lot more detail on the financial health of the borrower: €250,000 in Germany, €750,000 in Austria. The Austrians were attracting clients by advertising their lax rules.

Mr Traumüller agreed this was unfair and put a stop to such advertising, but his bankers continued to pinch the German banks' customers. So in February this year BaFin raised the German threshold to the Austrian level—another small step towards the harmonisation of European banking rules and that distant ideal, a single European market for financial services.

Yet in Passau the playing field is still far from level. For example, Germany and Austria have different rules on the taxation of interest income. Austrian banks simply deduct such income from client accounts and pass it on to the taxman without identifying the individuals concerned, whereas German banks have to tell the tax authorities exactly who was paid what. Austria has held on to its banking secrecy, whereas Germany has abandoned it, says Josef Leutzinger, a director of the Volksbank-Raiffeisenbank in Passau: “We act as fiscal agents for the government.” Even across a single border, where the countries on both sides have a common language and a common currency and are both members of the European Union, the two banking systems are a world apart.

Too important to leave alone

Governments even in the most liberal economies seem to feel that banking systems are too important to be left to themselves. The banks' role in taking deposits from the public and turning them into loans to oil the wheels of the economy is too crucial to allow the possibility of a shock, such as a bank failure or a

hiccup in the payment system. But different countries have different views on the use of the banking system as an instrument of government policy, and the lengths to which regulators should go to ensure the strength of their banking system. At one extreme is a state-owned banking system in which banks are extensions of government and will never be allowed to go bust; at the other is a lightly regulated system of private banks without an explicit safety-net in which bank failures are common.

Over the past 20 years, the role of governments in banking systems has tended to diminish, leaving room for doubt over whether banks might be allowed to fail. But over the same period some banks have grown so complex, and so active globally, that their failure would inflict severe damage on one or more national economies. These global banks are deemed to have become “too big to fail”.

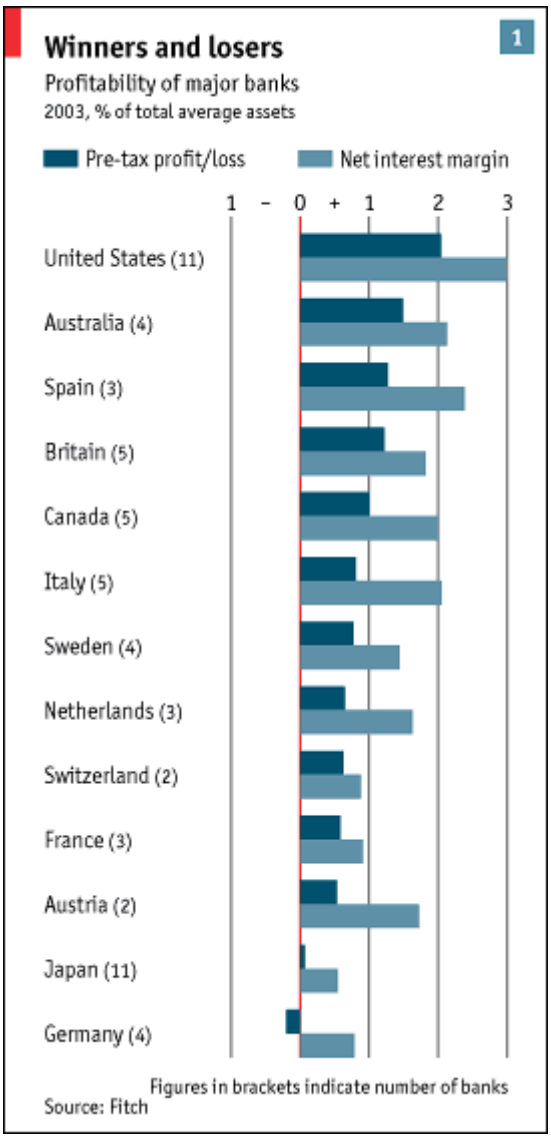
The Bank of England has estimated that a full-blown banking crisis costs the country concerned an average of 16% of GDP. In the past decade or so plenty of countries have experienced such crises, including Sweden, Turkey, the Czech Republic, Argentina, South Korea, Indonesia and Japan. Most of them would probably agree that this is something worth avoiding, even at the cost of banks being over-regulated and over-protected at a time when most other sectors are being opened up to global competition. Sovereignty over a banking system, even when the national currency has gone, appears to be one of the last things a country wants to give up.

One size doesn't fit all

But does it still make sense for banking systems to be protected and isolated from each other? The IMF and the World Bank, which jointly do a financial-sector assessment programme (FSAP) for any country that requests one, have been careful not to prescribe any particular paradigm.

Regulators in America—arguably the world's most successful economy—see strength in their financial system's diversity and fragmentation. It ensures competition not only between financial institutions but between regulators too. If a bank does not like one supervisor, it can switch to another. That keeps regulators on their toes and encourages them to embrace innovation. Why else, they ask, has most of the financial wizardry of the past 50 years come from America?

There are drawbacks, however. The fragmentation is messy and expensive and can lead to violent swings. For example, the lifting of restrictions on banking across state borders has led to frenzied opening of new branches in urban areas in Florida, New York, Texas and, above all, Chicago. Some of these places are already overbanked, but the frenzy continues. In the end some small banks will probably fail. But that is the American way: competition must not be stifled as long as the system itself is not threatened.



Other countries have taken quite a different route, curbing competition among their own banks and limiting foreign access or ownership. India, for instance, nationalised its banks between 1969 and 1991, but has slowly liberalised since, creating nine private banks to compete with the publicly or mutually owned ones. Yet foreign ownership has been severely restricted and looks likely to remain so. The Reserve Bank of India (the central bank) says that those restrictions saved India from contagion in the banking crisis that swept Asia in 1997-98. Others argue that the restrictions have in fact put India at a disadvantage. They point to Indonesia, which despite a banking crisis in 1997 is now growing slightly faster than India.

India's banking system was developed in the 1970s and 1980s as an instrument of government policy to finance public spending and investment by big companies. Only recently did the government recognise that this system is entirely unsuited to the millions of small, informal businesses that make up the bulk of the Indian economy. The transition to a banking system more closely aligned with the country's needs has proved painfully slow, and has not been helped by the Reserve Bank's abiding risk-aversion.

The European Union, for its part, is aiming for financial-market integration, but is being held back by its own diversity and by political disagreements about the purpose of national banking systems. For the past couple of years Italy has been the pariah, seemingly resisting one of the EU's fundamental principles: the free flow of capital among member countries. Even though a handful of foreign banks already had big shareholdings in Italian banks, the governor of the central bank, Antonio Fazio, for years insisted that Italy's banking system should remain largely Italian. Only strong representations from the European Commission persuaded him to give consideration to a bid in March this year by BBVA, a Spanish bank, for Italy's BNL, and another by ABN Amro of the Netherlands for Banca Antonveneta.

But Italy's is not the only European banking system to resist foreign buyers. Most German banks are still publicly or mutually owned and therefore cannot be sold. The same goes for half of the French banking system, and those in the know say that the big French banks that are listed on the stock exchange are simply not for sale to foreigners. Even in Britain, a foreign purchase of one of the dominant clearing

banks would probably be self-defeating: foreign-owned companies cannot be part of the FTSE 100 index, so British institutional investors would either oppose the bid or dump the shares after a deal.

Earlier this year, worries about competition prompted BaFin's Mr Sanio in Germany to appeal to his banks not to lend to companies at prices that did not cover their risks. Most continental European regulators seem to see nothing wrong with such warnings: Jean-Claude Trichet, as governor of the Banque de France, gave the French banks a similar scolding in 2001. American and British regulators have a more liberal tradition: let the banks make mistakes and leave it to the market to sort things out. Usually it works, but both America and Britain have had systemic crises in the past, notably America's savings-and-loans debacle of the late 1980s and Britain's secondary-banking failures of the early 1970s.

Can the Anglo-Saxon and the continental European approaches survive side by side? One force for convergence will be the new Basel framework for banks' prudential risk-management, known as Basel 2. The framework, negotiated by the Basel committee of rich-country bank regulators, is due to come into force in January 2007, but is already forcing bank supervisors to look closely at how their counterparts in other countries will apply the rules. The banks themselves want to ensure that their subsidiaries in other countries get consistent treatment. Whether this happens will depend on the competence of supervisors just as much as on the rules themselves.

Fear of failure

During the past 15 years or so international bank regulation has been concerned mostly with the ability of the system to sustain shocks, such as a stockmarket crash, a foreign-exchange crisis or a terrorist attack. To guard against systemic shocks, regulators require banks to carry a cushion of regulatory capital, so banks have higher costs than do more lightly regulated financial companies. But they have privileges too, including deposit insurance and access to the “discount window” (allowing them to borrow money from the central bank), under a long-standing pact between banks and regulators.

The banks' system of back-ups, capital buffers and procedures does indeed seem robust. Many of the world's biggest banks are extremely strong, with plenty of capital and a long record of high profits. Part of their strength comes from having passed some of their risks to others, including hedge funds, private-equity firms, insurance companies and pension funds. Some observers now feel that in view of this reduced risk, the regulatory capital banks are required to hold may be excessive and could be better employed elsewhere.

Regulators want to safeguard the strength and soundness of the banks they supervise, so they tend to shield them from the full force of domestic or external competition. But how far should they stack the cards in favour of licensed banks? If the banks enjoy too much protection, they have little incentive to compete on price or quality with other banks, or indeed with non-banks offering similar services. If they have too little, they may compete recklessly and ruin themselves—and perhaps the entire banking system with them.

Yet because banks are so heavily regulated, and to a large extent shielded from non-bank competition, it is difficult to know how much better they would do in a more liberal environment. Banks mostly compete with other banks, but on mutually accepted terms. In some markets, such as Britain's, that has led to dominance by just a few banks, despite apparently fierce competition between banking brands. When a handful of banks in a dominant position show exceptionally high returns on capital year after year, it suggests that potential competitors are being kept out. In Britain, that was the conclusion reached by a series of government-sponsored studies, which led to some attempts at corrective action.

Bank supervisors, because of their preoccupation with systemic risk, have tended to be quite tolerant of anti-competitive behaviour by banks. Banks have found that imposing high charges for making payments, and being able to use customers' cash while these payments are being processed, have been reliable sources of revenue, bearing little relation to the underlying costs. Anyone who wants to compete in these areas has to face the fact that almost every transaction ends with a payment into a bank account.

But now the pendulum is beginning to swing the other way. Bank regulators are becoming more concerned to ensure transparency in the way that banks operate and compete, and have realised that the real engines of an economy are the users of banking services, be they savers, consumers or businesses.

Moreover, some regulators worry that the credit risk and market risk which banks have traditionally borne is ending up elsewhere in the economy. That is fine if the new risk-takers, or their financial advisers, understand what they are doing; not so fine if it results in poorer returns from the pension and insurance funds on which everyone is relying to sustain an ageing population in future.

All this means that bank regulators will have to rethink their role. Perhaps they should be promoting leaner, less profitable, more utilitarian providers of basic services and recyclers of risk, leaving more of banks' traditional businesses to be picked off by non-bank competitors. Meanwhile, the insurance industry and the pension funds should be subject to more systematic regulation. The nightmare alternative may be a handful of megabanks with a stranglehold on financial services whose profits are largely protected from outside competition.

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The bare essentials

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What banks are for

IN DEVELOPED economies, nearly everyone has a bank account, because keeping cash under a mattress is neither safe nor convenient. Banks are an essential feature of national life, like buses, post offices and hospitals. Any money that is not floating around as cash, in the form of notes or coins, is either sitting in a bank account, or is in transit in a payment system between banks.

Banks operate by taking deposits from private people, on which they pay low interest or none at all, and using the money to make longer-term loans to other customers, charging them higher interest rates. Banking is based on trust, but banks sometimes misuse depositors' money or make losses on their loans, and depositors do not usually have the time, the inclination or the capacity to monitor their banks. They are happy to leave that task to governments.

Governments also help banks cope with temporary cash shortages by providing access to the “discount window” so they can borrow money from the central bank. The bank deposits are often insured in a pool arrangement or by the government itself, in case the bank goes bust.

Banks are also needed to make payments, sending money from one bank account to another, whether in the same bank or in any other one the world over. Even a payment by credit or debit card, or a mobile-phone billing account, ends up as part of a transaction with a bank.

These days most banks do a lot more besides, offering a wide range of financial services. For example, they give financial advice, exchange foreign currency, deal in securities and derivatives, and manage investments on behalf of clients. Regulators have an interest in making sure that these businesses are run properly; but their chief concern remains that banks are sound, that those deposits are safe and that the payment system runs smoothly.

Regulating banking systems is an uncertain business. Banks have to be discouraged from forming protectionist cartels and encouraged to compete with each other, but not so fiercely that they cut each other's throats. It is a delicate balance for regulators to strike.

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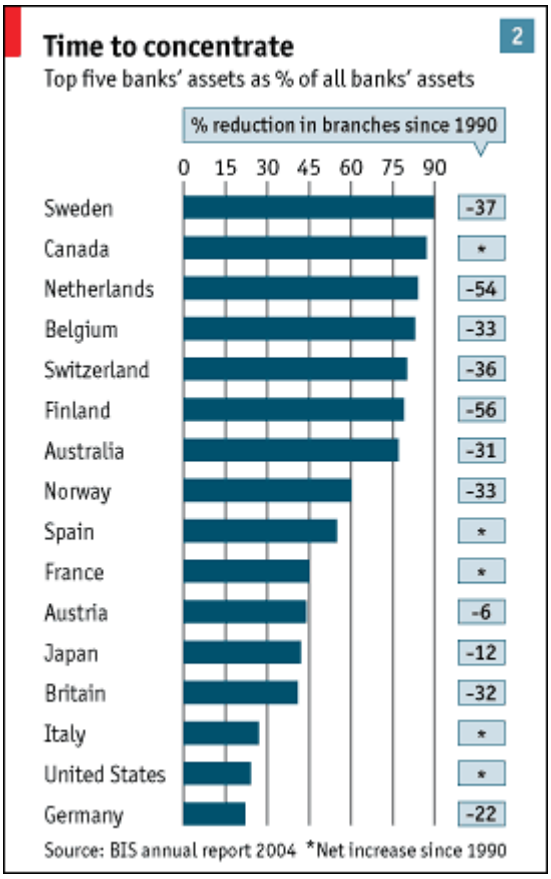
Don't start from here

May 19th 2005
From The Economist print edition

America's banking patchwork holds together, but only just



EVEN fans of the American banking system in its present shape admit that no one would have designed it that way from scratch: it simply grew, like the entire American nation, out of Wild West pioneering, revolution, retrospective fixing and constant tension between individual states and the centre.

The overall guardian of the financial system is the Federal Reserve, but big banks can choose whether they are regulated by state charter, which means they are supervised by one of 54 state banking departments (including those of Guam and the Virgin Islands), or by national charter, with oversight by the Office of the Comptroller of the Currency (OCC). Smaller state-chartered banks that are not important enough to be members of the Federal Reserve system, and institutions such as savings banks and industrial loan corporations, are supervised by the Federal Deposit Insurance Corporation (FDIC). Other kinds of savings banks, known as thrifts, come under the Office of Thrift Supervision (OTS). Credit unions are supervised by the National Credit Union Administration.

The Federal Reserve also has oversight of complex financial holding companies that own banks, and the Securities and Exchange Commission supervises complex financial holding companies that own broker-dealers. Insurance companies, some of which own or are part of banking groups, are supervised at the state level, and state supervision is co-ordinated to some extent by the National Association of Insurance Commissioners.

There are huge overlaps in what these different regulators do. Surprisingly, for instance, the New York State Banking Department oversees some of the country's biggest banks, with operations around the world. It has an office in London and until recently had one in Tokyo. Each state tends to have its own

approach to bank regulation. Since 1994, when American banks were allowed to branch out across state borders, banks have found it increasingly burdensome to report to the supervisor in each state where they operate. The OCC, a part of the Treasury, offers them alternative supervision by national charter.

Since January 2004, the OCC's rulebook for national banks has taken precedence over some consumer rules in various states, which makes life much easier for banks that cover a number of states. Last November J.P. Morgan Chase, America's second-biggest bank, got its supervision moved from New York State to the OCC. Over the past year five banks in various states have applied to switch to the national charter.

Some of America's biggest conglomerates—such as American International Group, General Electric and General Motors—own thrifts, which means that the OTS is not just some hillbilly domestic supervisor but oversees some highly complex and opaque global operations. Similarly, the Utah Department of Financial Institutions supervises some large firms which, for tax reasons and to attract cheap money in the form of insured deposits, have set up industrial loan corporations (quasi-banks whose deposits are insured by the FDIC) in the state. Among them are Merrill Lynch, an investment bank, and BMW and Volkswagen, two big German carmakers.

In 1999, the Gramm-Leach-Bliley act gave the go-ahead for financial groups to compete freely across sectoral divisions between insurance, commercial and investment banking. These divisions had become almost meaningless because the products concerned were often the same. The act also gave the Federal Reserve oversight of holding companies that include banking and other financial operations.

The chances are that American regulators will come up with more such fixes rather than a radical rethink. Individual regulators have a vested interest in doing what they do. Last October the Government Accountability Office (GAO) delivered a detailed report to the Senate Committee on Banking, Housing and Urban Affairs that suggested some sensible ways to consolidate American financial regulation. It offered four choices:

•To consolidate the regulatory structure into “functional” areas—banking, securities, insurance and futures—to create a first point of contact at the federal level.

•To move to a “twin peaks” model, with one regulator reponsible for the safety and soundness of the system and another for consumer protection and the conduct of business.

•To combine all financial regulation into a single entity, as some other countries—notably Britain, Germany and Japan—have attempted.

•To create a single entity to oversee complex global groups, but leave the rest of the structure untouched.

Consolidation had been suggested before, and 14 states have actually consolidated their supervision of banking, securities and insurance. But the response to the GAO's latest proposals was lukewarm. Apart from accepting the need for more co-ordination between regulators, not one of the many watchdogs thought the existing structure should be tampered with.

Alan Greenspan, chairman of the Federal Reserve, wrote to the GAO to say that Congress “should be careful to preserve the ‘dual' banking system, which has contributed greatly to competition and innovation in banking markets”. Donald Powell, chairman of the FDIC, said that the risk under a single regulator was the “loss of effective independent voices in the regulatory process”. And James Gilleran, then director of the OTS, defended the “healthy tension” between the federal banking regulators which made the American banking system the “healthiest, most innovative and robust in the world”.

Look back in sorrow

Really? As it happened, the predecessor of the OTS, the Federal Home Loan Bank Board (FHLBB), had presided over one of the world's most expensive banking failures ever. In 1989 the American government was faced with having to guarantee the dubious assets of practically the entire sector of savings-and-loans institutions. At the root of the problem had been moral hazard: recklessly managed financial institutions had enjoyed cheap funding

because the lenders knew they would be bailed out by the deposit insurer, the Federal Savings and Loans Insurance Corporation (FSLIC). The fiasco cost the government—ie, the taxpayer— $124 billion. The FHLBB and the FSLIC were wound up and replaced by the OTS, with the deposits insured by the FDIC. It was consolidation of a kind, but not one that reduced the number of financial supervisors.

Another notable failure of American regulation was the collapse of Long-Term Capital Management (LTCM), a hedge fund based in Greenwich, Connecticut, which had around 20,000 derivatives contracts with 75 different counterparties outstanding. One of the problems, identified by the GAO in a report after the crisis, was that “regulators continued to focus on individual firms and markets but failed to address interrelationships across industries.” More co-ordinated regulation might have spotted a systemic risk earlier.

The laisser-faire school argues that LTCM did not represent a systemic risk. LTCM's positions, even at the height of the crisis, had a positive market value which was spotted by at least one potential buyer: Warren Buffett of the Berkshire Hathaway insurance group. But regulators favoured a less market-driven solution, involving a consortium of LTCM's biggest counterparties that organised a soft landing for the hedge fund and its managers.

An even more egregious example of American regulators trying to shield their banks from market forces was the period in the early 1990s when Citibank and other big American banks were so weighed down by non-performing developing-country debt and real-estate loans that they were close to technical insolvency. The American government and the Federal Reserve engineered a period of steadily falling interest rates in which the banks could buy government bonds and trade their way out of trouble.

But the American market has so far proved big and diverse enough to ensure that such favours have not turned banks into a nationwide oligopoly. Some oligopolies had developed at state level, but the 1994 Riegle-Neal act, which for the first time since 1927 allowed banks to open branches in other states, put a stop to that.

Booming Chicago

The wind of interstate competition is truly blowing in Chicago. Over the past decade perhaps 500 new bank branches have opened in and around the city, and more are appearing every week. The most energetic expansion is coming from big banks such as Citigroup and Bank of America, although Washington Mutual and TCF are also pushing hard. Harris Bank (owned by Bank of Montreal), Bank One (owned by J.P. Morgan Chase) and La Salle Bank (owned by ABN Amro of the Netherlands) are more or less the incumbents, and they too are expanding.

For the moment, Chicago has the demography that growth-hungry bankers are looking for: it is the only really big city in a rich state with agriculture and diversified industry. In the suburbs, the banks are chasing affluent clients. Some communities have become so alarmed at the feeding frenzy that they, rather than the regulators, are limiting the number of new branches. But regulators at the Federal Reserve Bank of Chicago are sanguine. They agree that there is likely to be a shake-out, but predict that any problem banks will be bought up.

Much the same flowering of branches can be seen in New York, Florida and parts of Texas. The new bank branches are a far cry from the cavernous banking halls of old: they tend to look like boutiques. At branches of Washington Mutual, staff do not sit behind grilles or bullet-proof glass because there is nothing to steal. Any cash goes straight from the ATMs (automated teller machines) to the customers' pockets.

The hog cycle all over again

The fierce competition in Chicago shows what banks the world over tend to do when restrictions are lifted, a loophole is found or a new product invented. While margins are fat, more banks rush in; then incumbents and newcomers start cutting their margins to gain market share, and sooner or later the business is spread so thin that it cannot make money, but the frenzy goes on. A few banks fail, and somebody has to pay the bill: first the shareholders, then the deposit insurance, sometimes the taxpayer.

The alternative is for regulators to step in early and curb the competition. But in Chicago, American regulators prefer to wait. An official at the Federal Reserve Bank of Chicago explains: “If they're over-branching, it's not our job to tell them. But if we think a particular bank is being imprudent, we'll rate it accordingly.”

From a global perspective, a diverse and largely laisser-faire system in America may not seem such a good idea. It makes it harder to harmonise global banking regulation, as demonstrated by Basel 2, the new risk-based framework for bank capital adequacy that will take effect in 2007. The Basel Committee of rich-country supervisors, which is responsible for Basel 2 rule-making, found itself having to negotiate with a plethora of American financial regulators, though there was some co-ordination between the Federal Reserve, the OCC, the FDIC, the OTS and the various state banking departments.

The end result was that most American banks will not have to implement Basel 2. In America, the new rules will have to be applied by only about 20 internationally important banks, whereas in the European Union they will be observed not only by all banks but by all investment firms too. This makes Europeans feel that, as in other areas of American involvement abroad, there is one law for America and another for the rest of the world.

In the past year, all the biggest American banks—Citigroup, J.P. Morgan Chase and Bank of America—have been in trouble of one kind or another, caused by things like overenthusiastic bond trading, creating opaque financial structures for clients and deception of investors on behalf of borrowers. This suggests that conflicts of interest and bad behaviour on the part of employees tend to become more difficult to deal with as banks become bigger and more diverse. That may put a limit on further growth, but the banks do not seem to have acknowledged this yet.

The success of a handful of American banks in global wholesale and investment banking reflects well on their prudential regulation, and on the American business model. Part of their success, however, may be due to their active involvement in shaping the rules of the game over the past 20 years. They have been vocal lobbyists in the regulation of new markets and new financial instruments, and in negotiating accounting and conduct-of-business rules and measures of prudential capital. They were bound to influence regulators, particularly in areas where they had greater expertise, a phenomenon known as “regulatory capture”. The effect is reinforced by the way regulators and global banks tend to recruit experts from each other's ranks.

Moreover, rating agencies, whose main job used to be calculating the likelihood of borrowers defaulting on their bonds, now play a much bigger role: they assess the management of financial firms, and regulators have to take account of what they say. This introduces a bias towards capital-market and wholesale-banking criteria to which there is no real counterweight. Consumers and taxpayers do not sit at the table. Senate and House committees are good at picking up the pieces after a debacle, but they tend to produce quick fixes, such as the Gramm-Leach-Bliley act or the Sarbanes-Oxley act, rather than

conducting fundamental structural reviews.

We make the rules

These large financial institutions have had a big input into financial rule-making and the creation of new markets, such as electronic platforms for trading bonds, energy derivatives and foreign exchange. Sometimes accusations of cartel-like behaviour have prompted them to step back, as when they tried to establish a bond-trading platform, Brokertec, which they then sold to an independent broker. But there are few checks and balances on market-making in financial products that are not traded transparently on exchanges—and even there, restrictive practices by specialists and market-makers tend to continue for years before being checked. In Chicago, it took a rival exchange set up by Eurex, a European company, to eat into the margins of incumbent traders in the futures pit of the Chicago Board of Trade. On the New York Stock Exchange, it was an investigation in 2003 into the rewards paid to its then chairman, Richard Grasso, that began to question the fat margins charged by specialist market-makers.

Outsiders can play a useful role in exposing malpractices that have gone on for years, unquestioned by financial watchdogs. Eliot Spitzer, the New York State attorney-general, set out to protect private investors in his state of New York and speared a range of offenders, from stock analysts at investment banks to managers of mutual funds and makers of false markets in insurance contracts.

But it is not clear whether Mr Spitzer's exploits have achieved all that much in the longer term. Most banking cases he has brought have resulted in fines, not court cases and admissions of wrongdoing. Most settlements with Wall Street firms or big banks in the past few years have allowed the offenders to carry on much as before, and have cost the institutions concerned only a tiny proportion of their profits. Those who took the rap were mostly executives of companies that the banks advised, and investors in those companies' pension plans.

Europeans admire America's ability to deal with its scandals swiftly, even at the risk of being heavy-handed. In Italy, trials resulting from the collapse of Parmalat have been delayed by plea-bargaining, and have had little effect on conduct-of-business rules so far. In Britain, scandals over the mis-selling of pensions and investment trusts have yet to lead to prosecutions. America responded to the Enron debacle much more decisively, putting in place the Sarbanes-Oxley act, which requires top executives to take personal responsibility and disclose far more information than previously. The effect of Sarbanes-Oxley has also been felt by European companies that are listed on the New York Stock Exchange, or simply deal with other companies that are listed there, an example of the way national regulation tends to spill across borders.

Conversely, the European Union's efforts to develop a single market for financial services are producing some fall-out in America too. The EU Financial Conglomerates Directive of 2002 has forced American regulators to supervise groups on a consolidated basis, so that American financial groups which want to operate in Europe—and that means most of the big ones—need to be monitored by their home supervisor sufficiently strictly to qualify for mutual recognition.

In Europe itself, the single market for financial services has so far been a mixed success, as the next article will show.

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A blurred Euro-vision

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European banking integration is slow and imperfect

IT BEGAN as a dream in the 1950s to dissuade European countries from ever again contemplating war against each other. The European Coal and Steel Community of 1952 grew into the European Economic Community and, after the Maastricht treaty of 1991, the European Union. Whatever the label, the vision has always been to create a single, borderless economic area with common standards and without barriers.

Given the persistence of patriotism at the national rather than the European level, it is amazing how far the project has come. Most remarkable is the single currency, the euro, which since 2002 has allowed people to travel throughout 12 countries using the same notes and coins. For companies too—such as online shops, travel agents and mail-order firms—a big obstacle to operating in the euro zone was thus removed.

For banks, on the other hand, it was a bitter-sweet experience. Before the euro, they easily handled 15 different west European currencies and interest rates, and made good money out of trading cash, securities and derivatives for customers and for their own book. On January 1st 1999, when 11 currencies were irrevocably fixed against each other (the 12th, the Greek drachma, joined the euro two years later), ten out of 15 currencies vanished from traders' screens. Many European banks lost a chunk of their income.

The consolation was that, at a stroke, wholesale financial markets in Europe became much more integrated and more interesting for non-European investors. This caused much rebalancing of investment portfolios, because shares, bonds, loans and derivatives could be bought across the euro zone without additional currency or interest-rate risk.

On the wholesale side, the integration of European financial markets has been a resounding success. But on the retail side—bank accounts, payments, mortgages, insurance policies and personal investments—the process has hardly begun.

One strong sign that there is little convergence is the scarcity of cross-border banking mergers. So far there has been only one significant one, the purchase of Abbey National, Britain's sixth-biggest bank, by Banco Santander Central Hispano of Spain. One medium-sized French bank, Crédit Commercial de France, was bought by Britain's HSBC in 2000, and in the same year Germany's HypoVereinsbank bought Bank Austria. In Italy, another Spanish bank, BBVA, looks likely to succeed in its bid for Banca Nazionale del Lavoro, and ABN Amro of the Netherlands has been battling to take over Banca Antonveneta. Apart from some cross-border bank consolidation in the Benelux and Scandinavian countries, that is as far as integration in western Europe has got.

In central and eastern Europe, it is a different story. Since the early 1990s, large swathes of the banking sector there have been privatised and ended up in foreign hands. That has brought immediate benefits in terms of safety and soundness, fresh capital, innovation and integrity, although some economists are alarmed by the long-term implications.

East, west, home's best

Why the east-west split? Ask the head of a big west European bank why he has not bought up a rival in, say, France, Germany or Italy, and he will give two reasons. First, political and legal barriers to entry act as a disincentive. About half of the French banking system is still in public hands, and a foreigner would find it politically tricky to buy one of the three biggest banks, Crédit Agricole Lyonnais, Société Générale or BNP Paribas. In Germany, an even higher proportion of banks are in public or mutual hands, which means they are simply not for sale. There is a handful of private banks, but their share of the banking market is too small to give a foreign buyer critical mass. In Italy, several of the big banks are theoretically open to takeover, but real or perceived political barriers have discouraged foreign bids until recently.

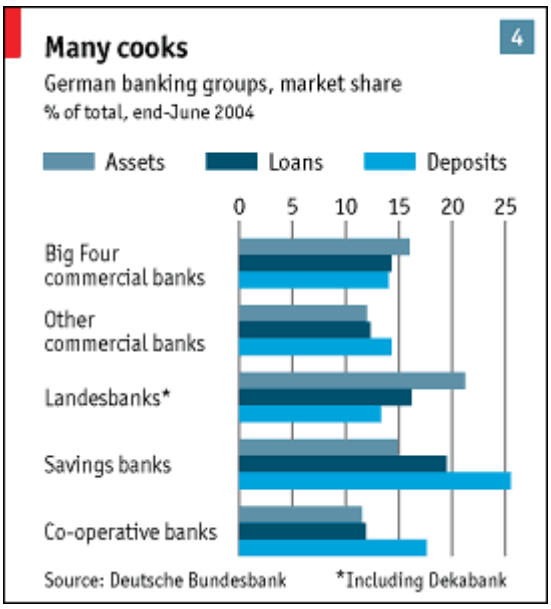
The second reason for not buying is that, in contrast to domestic mergers, the expected cost savings and economies of scale are rather modest. Domestic mergers benefit from the closure of branches and cuts in the number of employees and other fixed costs. Cross-border mergers are likely to bring only a few savings from the eventual integration of IT systems, back offices and perhaps the design and marketing of some financial products. But in general, even banks that have bought subsidiaries abroad tend to run them as separate banks. For example, Citigroup has not integrated its banking operations in various European countries, and nor have Nordea (the result of a merger of four Scandinavian banks), Deutsche Bank, HSBC or any of the smaller banks with subsidiaries in central and eastern Europe.

Doing their own thing

The reason is simple. When it comes to retail banking, each national banking system, whether inside or outside the EU, is still an island. Tax, ownership, consumer protection and conduct-of-business rules have not been harmonised. Despite the principle of mutual recognition, which is supposed to allow EU banks to operate branches in other EU countries under the supervision of their home regulator, simply opening branches in other countries does not win many retail customers.

Most big European banks have preferred to look for growth in more dynamic markets, such as America or Asia. The smaller ones have headed for central and eastern Europe. Most banking consolidation in the EU so far has taken place within individual member countries, for example in Spain, France and Italy.

A study by Morgan Stanley and Mercer Oliver Wyman, published in February, lays out the arguments in favour of cross-border mergers of European banks. It argues that the banks which are well ahead on IT and on complying with Basel 2 capital rules would be in a good position to buy up those banks that are behind, because they could make the laggards more efficient. The study's authors assume that banking integration in Europe is only a matter of time, because institutions such as the European Commission and the European Central Bank are determined to make it happen.



So what is holding it up? The single European market was supposed to be completed in 1992, but selling services across national borders turned out to need much more legislation and rule-making than expected. In 1999 the European Commission's directorate-general for the internal market drew up a financial-services action plan which was supposed to be completed by 2005. The rules for the wholesale market are more or less ready, but there has been slippage on the retail side.

The second banking directive, passed in 1993, allows for branching under the European passport. A directive on funds that can be sold across Europe has tried to stimulate a market in pan-European investment vehicles. An investment-services directive allows the cross-border selling of insurance and other financial products. But there are snags: countries can still invoke their own consumer-protection laws, and the tax treatment of investments and the legal status of mortgages, even of the ownership of securities, can vary. It is as though foreign tradesmen had been invited into the bazaar, but told they could sell only goods that are identical to the home-produced variety.

This is not true of other things that are sold across borders, such as cars, mobile phones, media or fashion. Is retail finance fundamentally different, or are incumbents unfairly protecting their turf?

The euro was expected to allow easy comparison of prices across all the countries that used it, and stimulate convergence. This has certainly worked for a range of items, from hotels to cars and cappuccinos. But comparing banking services from country to country is fiendishly difficult. A recent study by ING and Capgemini found huge variations in the price of core banking services, ranging from an average of €252 a year in Italy to €34 in the Netherlands. Another study, carried out by Mercer Oliver Wyman for the Italian Banking Association, compared the average price of keeping a current account in various European countries: €133 in Italy, €94 in France, €86 in Spain and €68 in Germany. But over 50% of Italians share bank accounts, which brings down the cost per person, said the study. And British and Dutch banks make much more money than do Italian ones from selling customers extra services such as mortgages and consumer loans.

Consumers in different member countries have different expectations of their banks. The British and Germans are used to getting free current accounts, but paying for cash withdrawals from other banks' ATMs. The French pay for their bank accounts but expect cash withdrawals across the euro zone to be free. Italians pay nothing for keeping a current account but are charged high fees for every transaction. Citigroup, which operates in most European countries, simply adopts the local price structure in each market.

An Italian, say, who wanted to save on bank charges by opening an account in the Netherlands or Spain would be faced with lots of obstacles. As a non-resident, he might be refused point-blank; but even if he succeeded, he would have to watch his step. In theory, any cross-border transfer in euros up to €12,500 should cost the same as a domestic transaction, but the code numbers for the recipient's bank branch and bank account must be given in exactly the right form, otherwise there is an extra handling charge.

Until March this year, French banks were forbidden by law to pay interest on current accounts. This law was overruled by the European Court of Justice last October after a challenge by a Spanish savings bank, and some are now paying interest.

Much of the lack of cross-border action is explained by customers' general unwillingness to change banks. People over 40 in particular hardly ever move their bank accounts, however bad or expensive the service they are getting. They may be missing out on cheaper deals, but most of them have better things to do than shop around for banking bargains. And many customers are proud to bank where their parents and grandparents did. This inertia gives the established banks a comfortable cushion of steady earnings that is only slowly being deflated by competition from internet alternatives, mortgage brokers and consumer-finance companies.

In Britain, various investigations have shown that banks have taken advantage of their dominant position by charging their customers high fees. The Cruickshank report in 2000 criticised the main British banks for overcharging small businesses in the knowledge that businesses in debt cannot easily change banks. Another study, by Stephen Martin and Michael Mainelli of Z/Yen Limited, analysed why big banks with dominant market positions, such as Britain's, may see little value in competing for new customers by offering cheaper and better services. First, customers seldom switch accounts, and if they do it is mostly because they are dissatisfied rather than attracted by something better. Second, the small number of new customers that would be won by offering cheaper and better services would not justify the extra cost. That is why the British market for personal current accounts is stagnant, the study argues. The big four British banks would “have most to lose if there was a culture of change in the personal current-account market”, the study says. It quotes a comment in 2002 by *Which?*, aBritish consumer magazine, predicting that change was unlikely until a “critical mass of organisations are willing to question the model of traditional banking and to spend enough money to change national perceptions.”

At least in Britain, as in America, small companies can turn to other sources of funding, such as venture capital and mezzanine finance. In continental Europe, such alternatives are harder to find, especially in Italy, where bank loans make up more than 70% of small-company finance. German and Italian banks traditionally have “house-bank” relationships with their smaller commercial customers. Newcomers seldom have the local knowledge to replace such relationships. But a few foreign banks, led by Royal Bank of Scotland and BNP Paribas, have been making inroads into the corporate-lending market in Germany, prompting complaints from local bankers that their already low margins are being forced down even further.

Germany is generally overbanked, and lending margins have historically been low because of the influence of the savings banks. Germany's savings banks are mostly owned by local authorities and guaranteed by them. Until recently they have been more interested in serving the local community than in making profits. That is changing slowly, mostly because, under pressure from the European Commission, their public guarantees will be phased out from July this year. Funding costs will rise, forcing those banks to charge higher margins.

Brussels theology

As discussed earlier, banks the world over are getting ready for the introduction of a new prudential capital framework, Basel 2, in 2007. The Basel 2 framework is being written into a new European directive that will cover all banks and investment firms within the EU. Its implementation will be as much of a challenge for supervisors as for financial institutions.

The framework rests on three pillars. The first is purely quantitative, assigning risk weightings to different types and maturities of assets, according to the credit rating of the counterparty, and relying on more sophisticated banks to calculate their own capital allocation. The second pillar depends on an assessment of the bank's management and performance by its supervisor, whose skill and competence could make a huge difference to how much extra capital the bank might be asked to hold. The third pillar concerns disclosure and market discipline: again, the ethics and disclosure standards of the local financial market will play a role. Harmonisation of regulatory and disclosure standards will be a nightmare, but European financial-sector regulators have chosen to rely on the principle of mutual recognition, that is, not second-guessing the competence of a bank's home supervisor.

A recent paper by the Centre for European Policy Studies (CEPS) in Brussels, which is partly funded by the European Commission, reinforces the impression that European financial regulation is a chaotic building site rather than the advertised level playing field. It argues that co-ordination between regulators is not developed enough to handle a Europe-wide financial crisis; and that consumers, or those representing their interests, do not have enough say in shaping financial-sector reform.

Faster rule-making, by expert committee rather than through legislation, may be speeding things up, but it favours financial practitioners and other powerful interest groups and risks “regulatory capture”—regulators getting too close to some of those they regulate. Four supposedly independent expert groups set up by the European Commission to review progress on the financial-services action plan were “overwhelmingly composed of industry representatives”, says CEPS. It also worries about the consistent implementation of the Basel 2 capital accord across EU states. But despite its criticisms, it is impressed with the European experiment.

Another study, by the Centre for Economic Policy Research (CEPR) in London, asks why progress on European banking integration has been so slow, and suggests that mutual recognition might usefully be complemented by a mechanism for arbitration on a European scale. Others have also suggested a Europe-wide financial ombudsman service for consumers, along the lines of the one operating in Britain.

The CEPR study asks some awkward questions about the pros and cons of cross-border banking integration, pointing out that strong competition from foreign banks could be a two-edged sword. It might allow bad borrowers to shop around more widely for loans, prompting banks to increase their lending rates for all borrowers. Moreover, foreign ownership of local banks may not necessarily be a good thing. “There might be sound economic reasons that justify domestic control of large local banks,” the study says. And it sees a potential problem for countries in central and eastern Europe whose big banks are mostly foreign-owned subsidiaries: “Problems in the parent bank may lead to a very rapid withdrawal of liquidity, jeopardising the entire banking system in the host country.”

Such foreign-owned banks also may be less inclined than locally owned ones to make business decisions that support the national economy, and perhaps more resistant to moral suasion or political pressure. That may be a good thing, leading to more realistic pricing. But then again it may put these countries at a disadvantage relative to some west European countries whose governments continue to exert political pressure on their banks. Still, the question is mainly of academic interest: some eastern European countries had little choice but to invite foreign banks in.

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Allegro ma non troppo

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From The Economist print edition

Italy's way with bank reform

ONE of Italy's biggest banks, Banca Commerciale Italiana, now part of the Intesa group, is not quite as Italian as it seems: it was founded, back in 1894, by a German-Swiss-Austrian consortium. More recently, Italy has shown itself to be progressive in other ways, making more headway with privatising banks than many other European countries—though mainly, it must be said, because the government needed the cash in the early 1990s. It was obliged to reduce its public debt drastically in order to qualify for euro membership by the starting date of 1999. That meant considerable consolidation in Italian banking in the past ten years, including the privatisation of most savings banks (something the French and Germans have not yet achieved).

There are now three main banking groups, UniCredit, Intesa and Capitalia, as well as a handful of medium-sized banks— Monte dei Paschi di Siena (the world's oldest bank), BNL, Banca Antonveneta and Banca Popolare di Lodi, which could consolidate into two more big groups. Even the biggest Italian banks are not huge by European standards, but UniCredit and Intesa have built up considerable networks in central and eastern Europe. They are among the few European banks to have retail operations in other countries' domestic markets.

The picture at home, however, is not that rosy. After the bankruptcies of Parmalat and some other poorly run Italian companies, the banks were rocked by a series of scandals in early 2004. Parmalat collapsed in December 2003, revealing a $17 billion hole in its accounts, about $3 billion of which was owed to Italian banks. But worse than Parmalat was the sale of many thousands of bonds issued by unrated Italian companies and offered to Italian mutual funds with minimal due diligence. Many of the bonds defaulted, damaging customers' confidence in Italian banks and bankers. This matters, because Italian private savers play a vital part in financing the economy.

In the past two years the banks, and the banking association, ABI, have made gallant efforts to regain some of that trust. ABI, for example, publishes a comparison of bank services on its website, guiding the public towards the best deals. It also puts its own rating on investments touted by the banks.

The banks, for their part, had to deal with a raft of non-performing loans, which required big clean-ups and recapitalisations. UniCredit and Intesa are now regarded as sound and stable. Capitalia still has some work to do, but Matteo Arpe, who took over as its boss nearly two years ago, has earned the confidence of the market.

A handful of European banks now see Italy as a promising market to buy into. Some already have considerable stakes in Italian banks: at the beginning of this year ABN Amro owned 9% of Capitalia and 12.7% of Banca Antonveneta; Crédit Agricole had a 16.9% share of Intesa; and BBVA had a 14.9% stake in BNL. Until recently the Bank of Italy, the central bank, seemed to be suggesting that a 15% share for a foreign owner was as much as it would tolerate.

This does not fit well with the EU's declared goal of a single European market for financial services. In February Charlie McCreevy, the new European commissioner for markets, duly wrote a letter to the Bank of Italy's governor, Antonio Fazio, asking him what he thought about foreign ownership of Italian banks.

Mr Fazio's power over what can or cannot be done in Italian banking is legendary. His appointment as governor is for life, and he has control over competition issues as well as prudential supervision. Politically, too, he seems to be bulletproof. He wrote back to Mr McCreevy to point out that foreign banks already own around 17% of the Italian banking sector, more than in most western European countries. For ABN Amro and BBVA, that was an unhelpful response. In mid-March, BBVA nevertheless notified the Bank of Italy and the market that it intended to make a bid for BNL. ABN Amro followed suit with a bid for Banca Antonveneta. Predictably, Italian suitors began to line up in preparation for a counterbid.

Deutsche Bank has a small bank in Italy, which it bought from Bank of America in 1986. But because the German bank has been schizophrenic about its own strategy, it has not made the best of opportunities in Italian retail or private banking.

The bank of Italy's protectionism can only do damage to Italian banks, says one Italian bank boss. But some Italian bankers are worried that foreign banks would be less inclined than domestic ones to lend to Italy's vast number of small companies. “You have to evaluate entrepreneurs,” says the head of a big Italian bank. “That is the bread and butter of the Italian economy.” German and French banks have let many companies go to the wall, the Italians note, whereas Italian banks feel some social responsibility for firms on their patch.

The Italian banks also have a record of coming to the aid of beleaguered Italian giants. In 2002, they bailed out Fiat to the tune of €3 billion, and last year they poured in funds to refinance Telecom Italia after its merger with Olivetti in 2003. “A bank in foreign hands might not have taken the same view,” says an Italian banker, insisting that sometimes a brand is worth saving: “That may be a better goal than looking at quarterly earnings.”

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The usual channels

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Banks want to keep their payment systems to themselves

MORE than three years after the introduction of euro notes and coins, it is still remarkably difficult to send euros from one euro-zone country to another without incurring ridiculous bank charges. True, since July 2003 a new EU rule, regulation 2560/2001, has required banks to charge the same for small euro cross-border payments as for domestic payments. But banks do not make it easy for their customers. Unless the international bank code number and account number are supplied in exactly the right format, most of them charge an extra handling fee. And few bother to tell their customers about the need for the special numbers in the first place.

Perhaps the banks deserve a little sympathy. Regulation 2560 was devised just before the introduction of euro notes and coins in January 2002. The European Commission was worried that unless Europeans saw some palpable cross-border benefits they would reject the euro, so it decided to make it cheaper for them to send payments up to €12,500 to another euro-zone country.

The banks were furious, because it does in fact cost them more to send people's money across borders, even within the euro zone. This is because most retail payment networks used by the banks are organised nationally. To send a payment outside this network, the bank usually needs an arrangement with a correspondent bank in the receiving country, which then uses its own national payment network to send the money to its destination.

Vested interests

The process seems hopelessly outmoded in an age of instant electronic communications, but the banks have invested huge sums of money in their independent national payment networks and do not want to throw them on the scrap-heap quite yet. The European Commission, on the other hand, envisages a single European payment area for corporate and retail customers by 2010. It now has to decide whether it should hurry things up with new legislation or leave everything to the market.

With regulation 2560, it gave the foot-dragging banks a push in the right direction, but it had not thought out all the consequences. There are still big discrepancies in how banks in different countries charge for payments. In France, for example, bank transfers incur a charge, but getting cash out of ATMs is free throughout the country. In Germany the opposite is true: bank transfers are free, but ATM withdrawals outside the bank's own network are charged for.

So in theory people armed with French cash cards can withdraw cash free from ATMs throughout the euro zone, whereas those with German cash cards cannot; but people with German bank accounts can make free transfers to any bank account within the euro zone. For now, if the receiving bank or the ATM operator imposes an extra charge, it is the customer's bank that ends up paying it, not the customer himself. No wonder the banks are enraged: they are being hit with the kind of arbitrary surcharges they usually reserve for their customers.

However, this provides them with an incentive to get on with creating a single European payment area. They have formed their own European Payments Council, but have yet to decide which of many possible routes to integrating their payment systems they should take. They could adopt one of the national systems, such as France's, which is very efficient, and extend it to the whole of the euro zone. But most

banks and regulators favour having two or more systems to guard against a network failure.

The European Central Bank (ECB) has already built TARGET, a pan-European wholesale payment system, but that is no good for retail payments. Both the ECB and the European Commission are reluctant to build a separate retail system: they would rather persuade the banks to do that. The banks already have the Euro Banking Association (EBA) system, intended purely for cross-border payments, and some experts favour developing that; but to date the volumes on EBA have been low, and it would still have to be integrated with national systems. The trouble is that cross-border payments in the euro zone make up only 1-2% of all payments, not enough to justify a big investment.

The banks have told the commission that they would rather bring forward the introduction of a single payment service (for large as well as small sums) to 2008 and absorb the costs of the transactions, leaving the development of a proper pan-European payment system until later. But the commission is getting impatient. In March this year, Charlie McCreevy, the single-market commissioner, threatened to bring in new legislation if nothing was done. A new directive might hurry up the banks, but it would be a retreat from attempts to find a market solution.

A recent report by the Centre for European Policy Studies says that EU regulation in general should not be pre-emptive but “should only respond to clear cases of market failure”. As far as the single payment area is concerned, it is not clear that the market has failed, only that it is not meeting the commission's expectations.

The European Commission is not the only one to lose patience with the banks. Some of the world's biggest companies are challenging the banks' reluctance to develop common standards for their customers to keep them up to date on the payments they are handling for them. TWIST (which stands for Transaction Workflow Innovation Standards Team) is a group formed in 2001 by Shell and includes other corporate giants such as Hewlett-Packard and General Electric. The group has led attempts to standardise and synchronise the payment instructions sent from customer to bank and back and the actual payments, so that its members know exactly what is happening to their cash.

Perhaps surprisingly, the banks are not yet equipped to give them this information in a common form: companies have to speak in a different language to each bank they deal with. Common sense cries out for change, but again the banks see little business reason for spending their own money. Several banks have become members of TWIST, “but this doesn't mean the banks have stepped off the fence,” says a corporate member.

Banks like to keep their customers captive. Payment systems are more lucrative for them if they are combined with other services such as cash management, foreign exchange or custody of securities. So banks are reluctant to see payments stripped out as a service that can easily be switched from bank to bank. This is true in retail banking too, where payments are often subsidised by interest-free deposits or services on which the bank can charge more. A study by the Boston Consulting Group looking at the decade to 2011 suggests that the banks will have to get used to tougher competition, more demanding customers and much lower profit margins.

Various consumer studies and regulatory actions on payment abuses seem to confirm that banks are lagging on payment technology rather than leading it. Once they have established a system that works, they like to maintain the status quo and hang on to their margins. Card payments are a good example. Payment by credit or debit card is undeniably convenient. Using a credit card is the most efficient form of cross-border payment. However, credit-card associations such as Visa and MasterCard have been tempted to take advantage of their market dominance to charge too much for the service and to shut out the competition.

Unfair interchange

In America, Wal-Mart, a giant retailer, led a class action against Visa and MasterCard, the world's two biggest credit-card associations, whose members include most of the world's biggest banks, for preventing merchants from steering customers towards using debit cards, which have lower transaction costs than credit cards. Visa and MasterCard agreed out of court in 2003 to pay merchants around $3 billion in compensation for years of unfair pricing. At issue was the so-called interchange fee, the percentage that banks charge merchants at the point of sale for processing a credit-card payment with another bank. But interchange fees have hardly moved since. A study by Morgan Stanley estimates that American banks earn around $24 billion a year from interchange.

The European Commission is investigating Visa for allegedly shutting out competitors in Europe. The case was brought by Morgan Stanley, which has its own Discover credit card and was refused membership of the Visa association. Britain's Office of Fair Trading has objected to MasterCard's interchange agreement with British banks, which it argues may be “anti-competitive” under EU competition law. French regulators clamped down on the big French banks for unreasonable pricing on payments with the French *carte bancaire*. In Australia, the Reserve Bank intervened in 2003 to force banks there to slash their interchange fees on credit cards.

Payments are clearly a tricky area for banks, customers and regulators. Under a rule of thumb used by regulators, banks should be allowed to co-operate freely when their counterparties are other banks, but must not collude on pricing when they are dealing with customers. However, such a rule is difficult to apply when dealings with the customer take place through an association owned by a number of banks. Some American lawyers argue that the very nature of interchange violates American antitrust laws, but an attempt to prove this in court in 1986 was thrown out. The lawyers say that today the court would find differently. For one thing, interchange prices have risen steadily over the years, whereas banks' processing costs have fallen.

In March the European Commission's competition commissioner, Neelie Kroes, ordered a fresh investigation into credit- and debit-card practices and retail banking generally in the EU. She wants a report by the end of the year, looking particularly at the way the interests of consumers and small and medium-sized businesses are being served.

The lack of competition in this area of banking is due partly to the concentration of market share among a few big banks. But customer inertia and the lack of information about alternatives also play a role. Many customers are dissatisfied with their bank but are hesitant to move elsewhere, as the next article explains.

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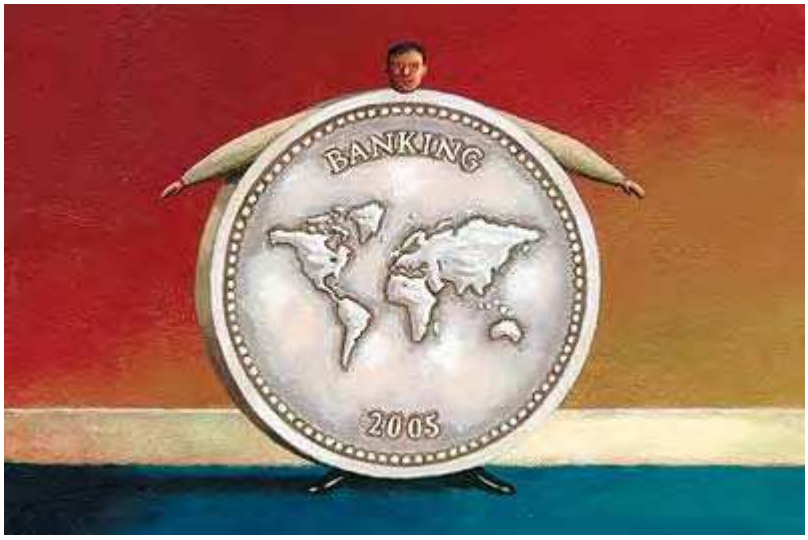
Is greed good?

May 19th 2005
From The Economist print edition



Sometimes banks can seem too profitable

IN A recent poll about the chief risks facing financial institutions, a senior British clearing banker pointed to the public perception of “greedy banks”. Last year Britain's four biggest banks between them made profits of £23.3 billion ($43 billion), a 16% return on equity. About £6.7 billion of that came from their retail banking operations in Britain. That means a profit of about £126 per customer.

Not even customers would like their bank to make a loss. However, there are two questions to be asked about such fat profits. First, do they point to a market inefficiency, ie, is there some reason why competitors have failed to provide cheaper services? Second, is the quality of these earnings good enough for the banks to rely on them in future?

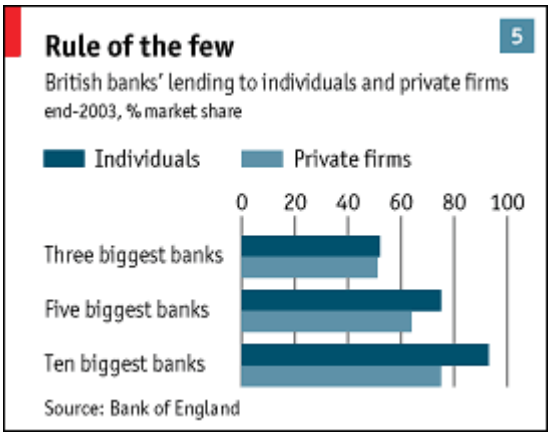
In Britain, competition from consumer-finance companies, mortgage brokers and alternative deposit-takers is certainly growing, but bank customers are very reluctant to switch their main account. The big British banks have generally been more successful than banks elsewhere at selling their depositors additional products such as unsecured loans, mortgages and insurance. The bulk of their recurrent earnings comes from that legacy of captive business—the so-called “back book”. But their dominant position as deposit-takers of choice is slowly being eroded, so any competitive inefficiency will not last.

As for the quality of earnings, it seems that the British banks are world leaders at confusing their customers and extracting extra charges. One area of rich pickings is overdrafts, particularly the unauthorised sort. *Which?*, a magazine published by the Consumers' Association in Britain, calculates that in 2003 banks made more than £3 billion from charges for unauthorised overdrafts. In an article published last September, *Which?* showed that customers pay anything from £18 to £30 for stepping over the mark, and a lot more if the overdraft continues, usually £5 per day, up to a maximum of £80 a month, with perhaps £25 added for each extra transaction. That does not include interest charges on the actual overdraft, which can be as high as 34% at an annual rate.

Nobody pretends that such fees bear any relation to costs. The banks say that they have to charge high rates to cover the credit risk of defaulting customers, and that this subsidises cheap banking for good payers. But they do not make it easy for customers to compare and understand their scale of penalties. All British banks have signed up to a voluntary banking code obliging them, among other things, to give 14 days' notice before applying charges for “standard account services”; whether that includes unauthorised overdrafts is unclear.

Banks and loan companies play the same game with late payments and with repayment insurance on credit-card accounts, says *Which?*, noting that of 2,000 people interviewed, “a staggering one in four people were charged at least once for paying late or exceeding their credit limits.” That netted the banks around £427m. A repayment-insurance premium added to a loan, sometimes without the borrower's knowledge, can sneakily double the borrowing cost.

Another, less tangible, problem is borrowers being tempted to run up debts that they cannot manage. Banks or credit companies often arbitrarily raise borrowing limits without alerting the borrower or doing a credit check.



Two of the statutory responsibilities of the Financial Services Authority (FSA), the industry's super-watchdog in Britain, are to promote public understanding of the financial system and to secure appropriate protection for consumers. Being “fair to the consumer” is a slogan the FSA has championed. But the FSA has little to say about correcting anti-competitive behaviour by banks. It insists it is “not a competition regulator”: that is the job of the Office of Fair Trading. But the banks may be unwise to rely on gouging unwitting consumers for some of their future earnings.

Some French banks too have been making large profits in their domestic market, prompting a study last year by *Que Choisir*, the French equivalent of *Which?*, into French banks' charges for routine services. *Que Choisir* calculated that French banks charge a margin of between 35% and 100% above the costs of technical banking services such as payments by cheque and online, direct debits and other account services. In most cases the margins have risen dramatically between 1999 and 2004. On the other hand La Poste, the post office bank, has been running such services below cost.

Germany's banks probably wish they had the French banks' problems. The pressure on margins in Germany is so strong that many banks cannot make a profit from everyday retail banking. A decade or so ago this was mainly because of competition from the savings banks, and to some extent the co-operative banks, which together make up about half the market, and at that time had little interest in making profits. Savings banks are mostly owned by the local authority and have a political and social role. Co-operative banks are owned mutually and are run for the benefit of their members. The private banks tried to compete on the same terms, spreading their network of branches widely and triggering a price war.

Germanic gloom

The big German banks have been paring their costs and closing branches, but they still cannot make retail banking pay properly. One exception is Deutsche Bank, which has concentrated on the affluent and reported a 22% return on equity in this sector for 2004. As for the rest, the phasing out of the savings banks' public guarantees from July this year should widen their margins a little, and Basel 2 may also help.

It was foreign banks, entering the market without preconceptions, which showed that well-targeted retail banking could be profitable. Back in 1973, Citibank bought a small bank, Kundenkreditbank, and has turned it into one of the most successful small banks in Europe, with a return on equity in 2004 of 39%. Dutch-owned ING DiBa has been drawing customers by offering high rates on internet deposit accounts.

But the environment is getting ever tougher. Postbank, mostly using the branches of Deutsche Post, its majority owner, claims to have 11m customers and is expanding its range of products. Banks owned by carmakers are growing rapidly, targeting the more affluent customers. VW Bank, Audi Bank, DaimlerChrysler Bank and BMW Bank provide not just car finance, but credit cards and asset management too. “They have a fantastic branding advantage,” says a retail chief at one of the big banks. “Walking into the branch of an ordinary bank does not give much pleasure, but someone who has just bought a new BMW likes the idea of a BMW credit card and a BMW investment fund.”

Does all this competition mean that the German customer is getting the best and cheapest deal in Europe? Up to a point. But German banks have generally been competing on price, not service. For example, branches tend to close for two hours at lunchtime, just when working people want to use them. To be fair to the management, it is usually the bank workers' representatives who insist on the break.

An alternative society

Many people thought that the internet would come to replace the simpler parts of the banking system. If you can order goods, bid at auctions and download articles, music and films, then why not use the internet to bypass banks and send each other money? It hasn't happened. Nor has the mobile phone replaced the wallet, except for buying trivia such as screensavers and ringtones.

No non-bank has yet been able to command the trust that a non-trivial financial transaction requires, so transactions online, by mobile phone or by credit or debit card still begin at a bank account. Even PayPal, which is used for payments on eBay, an internet auction site, is only an intermediary between the bank accounts of the buyer and seller. There are also various internet projects to provide business-to-business (B2B) payments without bank intermediation, but again the trust is absent.

One experiment with storing savings electronically is e-gold, which allows subscribers to invest in gold electronically and pay for goods and services on the internet in units of gold from their virtual account. That is tantamount to creating a new currency. But the project has not taken off. At the last count the total of the gold “currency” in circulation was only $28m.

Electronic purses or cards with cash stored on them are beginning to appear. Octopus cards in Hong Kong and Oyster cards in London are among the loadable card schemes used on public transport. These cards can also be used to buy goods at newsstands. But they are no substitute for a current bank account.

Mobile-phone companies have also flirted with using their billing accounts as a way for subscribers to pay for large items as well as small. Simpay, a project sponsored by several mobile-phone operators including Vodafone, plans to launch an operation by mid-year in Spain, followed by Britain and Belgium, but initially only for items below *euro*10.

New experiments with financial services on the internet keep popping up. Sparschwein AG is the latest offering from Munich. Sparschwein (German for piggy-bank) appeals to the Germans' enthusiasm—nurtured in the lean years after the second world war—for saving pennies and for recycling, but with a difference. It encourages them to unlock the dead capital they have in their attics and cellars, in the form of unwanted antiques, exercise bikes, computers, hi-fis and a host of other things. Sparschwein agents will come round and assess the goods, and if they like them store them in one of two warehouses in Germany. Then Sparschwein helps the customer auction the goods on eBay. The proceeds go into the customer's Sparschwein account.

The founders of Sparschwein are interested not only in getting goods to auction, but also in developing a secondary market for pieces of paper with a residual value, such as unexpired mobile-phone contracts, life-insurance policies, health-club memberships and so on. Matthias Kröner, co-founder of Sparschwein, is thinking of getting into closed-end property funds, some of which might be available at distressed prices. “We're the classic recyclers of the financial-services sector,” he says.

But Sparschwein itself is not a bank. The customer accounts are held at Deutsche Kreditbank, a subsidiary of Bayerische Landesbank. Once again, underneath the icing of innovation, the trusted third party turns out to be a bank.

In London, Zopa is trying another new idea: cutting out the intermediaries in borrowing and lending. Zopa stands for “zone of probable agreement”. The company, again largely internet-based, aims to get potential private lenders and borrowers together, establishing a rate that both sides are comfortable with (a zone of probable agreement). Rates for individual borrowers are guided by the borrower's personal credit rating provided by Equifax, a credit bureau. Cash committed to lending is spread over a minimum of 50 borrowers, and the exposure per lender is limited to a maximum of £200 for each borrower. Zopa makes its money by charging the borrower an arrangement fee of 1%.

Whether it will take off depends on the number of people self-confident enough to go outside the usual banking channels. It has already seen interest from societies and minority groups that would like to lend to people within their own circle. Again, Zopa does not pretend to be a bank; it is regulated as an introducing broker by the Office of Fair Trading, and as an introducer of credit insurance by the Financial Services Authority. The debits and credits are held in a client service account at the Royal Bank of Scotland.

Self-help groups that club together to reduce their borrowing costs are nothing new. They are one way of getting finance to the poor, an area neglected by the banks in places such as India. The Indian banking system is heavily controlled by its central bank, through a network of publicly owned banks, and shows

little sign of liberalising, as the next article will show.

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Indian defence

May 19th 2005
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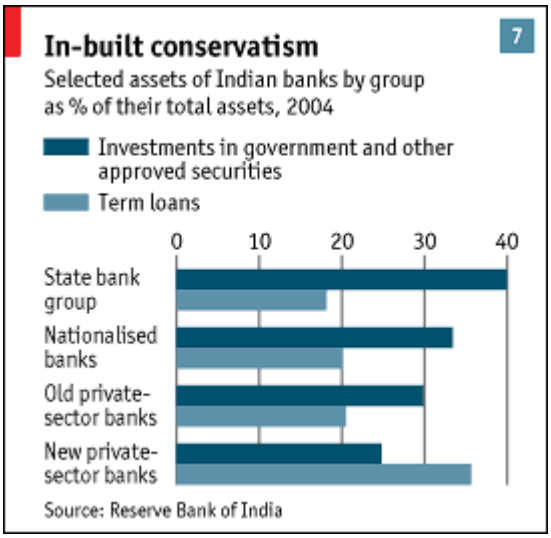
How bank regulators keep out competition



NEW office blocks and condominiums sprout along the Mumbai waterfront as bulldozers tear down the shanty towns inland. This is progress of a kind, though it would be more even-handed if the displaced slum-dwellers had somewhere better to go. India's banking system too is being upgraded, but to many people in the country this is just as irrelevant as the construction of those new office blocks: they have no access to finance.

For two decades in the late 20th century the government tried to make big changes in the way the economy was run, nationalising the banks and nannying strategic industries. After 1991, it began to embrace the idea of the market, but the Reserve Bank of India (RBI), the central bank, is clinging to some of the old values. The 20 public-sector banks, representing three-quarters of all banking assets, are still at least 51% owned by the state and will stay that way. The RBI will also keep a tight rein on any investment by foreign banks in local private banks above a 10% limit.

The central bank puts moral pressure on banks to charge low interest on loans to “priority” sectors such as small companies and agriculture. But at the same time it is trying to update the system and to get it to conform to the Basel 2 risk-management principles and capital measures. Critics say the RBI is obsessed with avoiding bank failures. It congratulates itself on having kept India out of the financial crisis that swept Asia in 1997-98. Contagion from such a crisis might have cost India 15% of GDP over the following few years, as in Malaysia and Indonesia. However, the cost of failing to liberalise the banking sector may turn out to be even higher in the end: around 2% of GDP per year, according to a World Bank estimate.

India's banks are generally sound. Some of them have recently made returns on equity of up to 16%, but not by lending. Up to 40% of some Indian banks' assets are invested in government bonds and other state-guaranteed instruments, way beyond the statutory liquidity requirement of 25% (see chart 7). One reason is that downward pressure on lending rates by the RBI has made banks reluctant to lend to anyone who presents the slightest risk. Besides, thanks to the government's successful war on inflation, holding bonds has been an easy way to make money.

Most of the impulse for change and competition has come from the “new” private-sector banks that were allowed to develop after 1991. There is also a handful of foreign banks, led by Citigroup, HSBC and ABN Amro, that have brought more competition to areas such as consumer lending and servicing private clients.

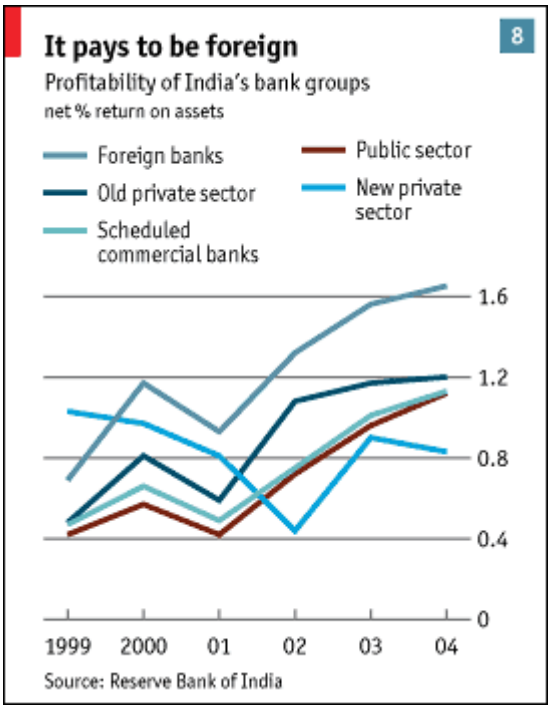
For a country as big as India, and as much in need of basic development finance, financial-sector liberalisation presents a dilemma. The Indian capital market is one of the most vibrant in the world, with over 5,000 companies listed on the stock exchange and a lively corporate-bond market. But banks are still regarded as something special.

Kid-glove treatment

In a report on financial-sector reforms last October, Rakesh Mohan, deputy governor of the RBI, defended India's way of dealing with banks at risk of insolvency, which has usually been to merge them with a healthy public-sector bank—despite the "moral hazard" involved (banks may behave more recklessly because they know they will be saved). What has swayed policymakers, says Mr Mohan, is that India's commercial banks are the most important segment of the financial system, and that over 70% of bank depositors are small. But he admits that as private banks begin to play a bigger part, the moral-hazard problem will require further thought.

The public banks themselves feel that they have responsibilities not just to shareholders but to many stakeholders, including "our customers, employees, the general public, the government", says the chairman of one public-sector bank, "though working on sound banking principles", he adds.

The RBI offered its take on the special nature of banks in its December 2004 bulletin: "The owners or shareholders of the banks have only a minor stake, and the considerable leveraging capacity of banks (more than ten to one) puts them in control of a very large volume of public funds in spite of their own stake being very small. In a sense, therefore, the owners act as trustees." Banks are a special type of financial intermediary that needs appropriate treatment by regulators, says the RBI, including special measures to protect them from competition and the risk of failure.



The World Trade Organisation, under its General Agreement on Trade in Services (GATS) programme, has been banging on India's door since 2000, trying to persuade it to open up more to foreign banks. But the RBI has its own agenda. For example, it treats branches of foreign banks as if they were local subsidiaries, insisting that they must carry enough capital to cover their business in the country.

The Indian government's attitude to foreign investment in its banks has hardened over the past year. In March 2004 it had indicated that foreign banks would be allowed to own up to 74% of an Indian bank, but in February this year it said that direct investment by foreign institutions in Indian banks would have to be reduced to 10%. Anything above that level would be limited to banks earmarked for restructuring, and would be carefully phased in.

The bank seems to feel that Indian-owned banks are more likely to act as instruments of government policy. Certainly much remains to be done to spread banking to the parts of the economy it has not yet

reached. According to a World Bank study, 79% of rural households do not have access to formal lending. Of the households surveyed, 44% said they had used informal lending channels over the past year. That can include loans from family and friends, but well over half this finance comes from unregulated moneylenders who charge an average annual interest rate of 48%. There is clearly huge scope for cheaper, more formal lending. One reason banks are not pursuing this market is that the RBI and local authorities discourage them from charging interest of more than 14%. Some rural banks get round this by demanding bribes. Micro-lending, by micro-finance institutions or by self-help groups (in which borrowers club together to provide collateral), is increasing. But it reaches only around 5% of India's poor, against 60% in Bangladesh.

What may be even more important for the economy is to provide access for the 92% of Indian businesses that do not use bank finance. That represents an enormous potential market for both local and foreign banks, but the present structure of the banking system is not suitable for reaching these businesses. Securitising micro-loans—bundling many loans together and selling the resulting cashflow as a security—may be a way of achieving economies of scale. One private bank, ICICI, securitised $4.3m of micro-loans last year. But most Indian banks are more interested in competing for affluent customers.

Ironically, the impressive information technology that India supplies to customers the world over has not yet found its way into Indian banks. Most of them are struggling with integrating their front-office and back-office systems and with allowing their customers to access their accounts through different channels: internet, ATMs, telephone and branch. Most American and European banks cracked this problem years ago. But it is easy to forget the vastness and backwardness of much of India: some villages are still waiting for electricity, though mobile ATMs make periodic appearances on the back of a truck.

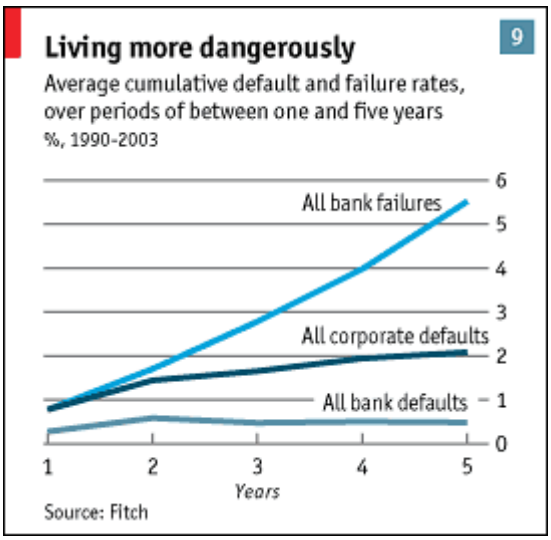
Never say die

There are conflicting views on whether there are circumstances in which the protection of banking systems can be justified. A paper on “Bank Concentration and Competition” by a group of people from the Federal Reserve, the World Bank and other institutions, published in September 2003, draws the following conclusion:

> More regulatory restrictions on bank competition are associated with “bad” outcomes— such as less favourable prices for customers, less access to credit, and reduced stability of the financial system. Less binding impediments to foreign bank ownership and entry are generally associated with more favourable prices for customers and more access to credit (“good”). State bank ownership is generally associated with less access to credit and reduced financial-system stability (“bad”). Thus, policies that restrict bank competition—regulation, barriers to foreign participation and direct state control of banking resources—tend to be associated with “bad” outcomes and diminished overall economic performance.”

However, there may be circumstances in which state control is helpful—for example, for restoring health to an economy after a banking crisis. Too often, argues Richard Werner, professor of international banking at Britain's Southampton University, banks are rescued and recapitalised after a crisis but remain understandably risk-averse and will not lend. So the economy is starved of credit just when it needs it most. The special role of banks as creators of credit must be recognised in any banking reform, says Mr Werner. He counsels that governments should intervene early to prevent such crises, but if they fail to do so, they should ensure that banks make new loans by using the central bank as a creator of credit.

This flies in the face of IMF orthodoxy and most current thinking about the role and nature of banks and bank lending. But orthodoxy is one thing; what governments actually end up doing is another. For example, the Hong Kong Monetary Authority bought shares on the Hong Kong stock exchange in 1997 to keep asset prices up and save banks from a financial crisis; and Japan's central bank has led many “price-keeping” operations in the past decade to prop up the value of banks' equity portfolios at times of crisis.



An analysis of bank failures in the past decade by Fitch, a rating agency, shows that although many banks “failed”, few defaulted on their debt (see chart 9). Usually they were bailed out by their home government or rescued in some other way to avoid a default. Fitch's figures show that banks were 11 times more likely to be supported when they failed than they were to default, but also twice as likely as non-bank companies to fail or default. So perhaps it is understandable that countries such as India and Italy try to protect their banking systems from foreign control until they have become stronger. Countries that have opened up to foreign banks often have one or more strong banks to champion national interests.

Whether the banking model is open or restrictive, regulators do not like banks to get into trouble: they want to ensure that they are strongly capitalised and resistant to default or failure. But can capital adequacy be overdone? Some argue that an over-strong banking system absorbs economic resources that could be better used elsewhere, as the next article explains.

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Crusader castles

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Building impregnable banks carries its own dangers

“WE ARE fortunate in the United States today to have a strong financial system. This system has a tremendous capacity to match capital to ideas, reward innovation, and channel savings to the highest return. And it has demonstrated a capacity for very considerable resilience and stability in face of shocks.” So said Timothy Geithner, president of the Federal Reserve Bank of New York, in February this year. The banks were a primary source of this strength, he told a gathering at the Economic Club in Washington, DC, and with their higher earnings, stronger capital and greater diversity they would withstand even bigger shocks than before.

Medieval engineers built many daunting castles with thick walls and redoubts that made them seem impregnable to the armies of the day. But sooner or later they were destroyed or simply by-passed by invaders. In the same way, the big banks that dominate the financial landscape at present may turn out to be less secure than they seem.

Bank regulators, led by the Basel committee of rich-country supervisors, have spent the past 20 years trying to build up the banking system. In the mid-1980s they had a reason: banks were severely undercapitalised, and any collapse might have jeopardised the entire financial system.

The Basel committee did a good job. By the mid-1990s, most bank regulators around the world were enforcing a capital-to-assets ratio of 8%, known as the Cooke ratio. Over the years, that ratio has been refined to take account of different kinds of capital and the riskiness of different assets and exposures. But the basic principle still applies: a bank must have a layer of capital to cushion it against unexpected shocks. Regulators, rating agencies, equity analysts and economists see bank capital as an important measure of a bank's health.

The Basel committee's new risk-based capital framework, Basel 2, revolves around how capital is allocated and how much capital is set against various risks. Basel 2 principles have already been factored into most expert assessments of banks. In short, the Basel regulators have won: they have made sure that the banks are strong, and will become even stronger.

Someone else's problem

But, like those medieval engineers, they may be concentrating too much on their castles and not enough on the surrounding countryside. Some economists and experts on financial systems have begun to take a broader view. They liken the world financial system to a biosphere, complete with governments, banks, securities firms, corporate treasuries, insurance companies, pension funds, mutual funds and householders. If the financial risks contained within that biosphere are passed on or “managed” away by one bunch of risk-takers, they do not disappear into thin air: they are borne by another bunch of risk-

takers elsewhere in the system.

In the past 20 years, banks have become increasingly skilled at “unbundling” risk, keeping the bits that they like and passing the rest elsewhere, usually to applause from regulators and markets. The methods they have used include interest-rate swaps, derivatives, currency, equity and commodity futures, and asset-backed securities. A lot of these risks have popped up in the portfolios of insurance companies and pension and mutual funds.

Perhaps the greatest innovation in the past ten years has been the banks' unbundling of credit risk. Their ability to sell loans, or to pass on the risk involved in the form of credit derivatives, has begun to transform the way banks do business. Historically, credit risk has been the cause of most bank failures. Banks used to increase their lending at the peak of a business cycle and then had to sit with the loans through the next credit crunch. No longer.

But what happens if the part of the financial biosphere that used to hold the bulk of credit risks, the banks, passes them on to someone else? The IMF's International Capital Markets Department has recently examined that question in a series of studies, on insurance companies, pension funds and households. Its insurance study looked mainly at the effects on life-insurance companies. It found that the life-insurance industry was already handling a big slice of credit risk in the form of loans, corporate bonds and credit derivatives, and had an appetite for more. But insurance companies, like the banks, were becoming more adept at reducing the risk on their own balance sheets, the study noted: “It is likely that such risk will continue to be passed to less sophisticated participants, namely to policyholders and hence to the household sector.”

The pensions study showed a general move by pension funds towards allocating more assets to bonds rather than equities. With pension funds increasingly moving away from defined-benefit schemes and towards defined-contribution ones, again households were being asked to bear more financial-market risk, the study found: “This risk-transfer raises the question of how well equipped households are to bear such risks.”

The final study, on households, concluded that these are indeed carrying more of the risks contained in the financial system, which it defined as follows:

•Market risks, ie, interest-rate, equity and credit risk, as well as derivatives embedded in structured products.

•Inflation risk, as governments and companies adjust or eliminate the indexation of benefits.

•Investment planning and reinvestment risk, ie, operational risk.

•Longevity risk, as public and private annuity income streams are reduced or eliminated to take account of longer lives.

As households take on more of these risks, they are also being saddled with more complex financial instruments, such as equity-linked bonds, credit-linked notes and so on. It would be good to think that the process of risk transfer filters out the most toxic elements and offers households a steady accumulation of value, but the chances are that the opposite is happening. Banks have tended to pool the cheapest (that is, the most heavily discounted) risks into baskets of assets which they then securitise. Rating agencies have assisted with this process by assigning ratings to these asset pools, ignoring the variations in the quality of individual credits within each rating band. Rating agencies should not be relied on as the “primary monitor of these systemically important markets”, one of the IMF studies notes.

Households are not likely to have the time, inclination or ability to evaluate such offerings from banks, and financial advisers and fund managers do not have a good track record of explaining complex financial products. The study rather lamely concludes with the hope that policymakers will provide households with education and advice on financial-risk management.

But who would these policymakers be? Regulators' first priority is the safety and soundness of their banks. If pushed by their governments, they might also look at the public-policy function of the banking system and the related capital markets. But very few regulators, or even regulatory economists, look at the full financial food chain—savers, retail banks, investment funds, borrowers and issuers of debt, capital markets, pension funds, insurance companies and back to savers and consumers.

If that is to change, financial regulators must develop a rounder vision of what banks and financial markets are for, and for whose benefit they are being run. That does not mean a creeping reappearance of the nanny state. The past 20 years have shown that market forces, for all the abuses that may happen, are a fairer means of distributing assets than quotas or five-year plans.

But regulators must recognise that they are serving constituencies beyond the institutions they are regulating. The magic circle of banks, their supervisors, rating agencies, stock exchanges, electronic trading platforms and asset managers must not be allowed simply to reinforce itself. Regulators have to keep asking themselves whether the markets and entities they are regulating are distributing assets as fairly as possible. Markets are not perfectly efficient, and information and prices do not travel unhindered within the financial biosphere. But maintaining artificial barriers, as in India and Italy, can be only an interim solution: in time, the tide of globalisation will wear those barriers down, even if a residue will always remain because of the special nature of banks and their role within the financial system.

Financial regulators must also guard against “regulatory capture”—identifying too closely with the interests of those they regulate. It has often taken an outsider, such as Eliot Spitzer in America or *Que Choisir* in France, to point out abuses that have become ingrained. And regulators and overseers should avoid behaving as if they have all the answers.

Above all, consumers and small entrepreneurs, the backbone of most economies, must find a new voice, either on their own or with the backing of well-organised expert groups. Such expert groups should include people with experience of how the financial system works and how it can be changed, both technically and politically. But people like that are hard to find, because they usually get snapped up by the financial institutions, where they are highly valued and highly paid.

There are rays of hope on both sides of the Atlantic: from the fragmented American regulatory system which, for all its faults, is internally competitive and open-minded enough to bring about change; and from the work-in-progress in Europe to create a financial market to serve a vast new economic area.

The long road to competition

But it seems unlikely that national banking systems will knit together into a larger international entity in the near future. Local idiosyncrasies, national pride and political meddling have not disappeared, and the international playing field remains bumpy. Banks' core activities—taking deposits, providing credit and handling payments—seem to be too important to be left to free competition.

All the same, outside competitors should be encouraged to chip away at the banks' franchise. And when the banks take unfair advantage of their privileged position, regulators, customers, competitors and outside observers must pipe up.

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Aviation in America

Flying on empty

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America's airlines have managed to keep flying with the help of some unusual friends. But for how much longer?

Get article background

EVERYONE else in aviation makes money while airlines just do the flying. So says Giovanni Bisignani, boss of the International Air Transport Association. His point is that airports, component-makers, aircraft-makers, banks and so on make a nice living, while most airlines chronically fail to turn a steady profit. Nowhere is this more true than in America, roughly half of the world's aviation market.

America's six big traditional carriers have lost a total of $27 billion since 2000, yet they are all still flying. One of the top six, US Airways, is enjoying Chapter 11 bankruptcy protection (which keeps creditors at bay while the business goes on) for the second time in recent years: its latest wheeze is to merge with America West, another troubled airline. United Airlines, the country's second largest airline, has been stuck, battling the unions and creditors, in Chapter 11 for 30 months.

The terrorist attacks of September 11th 2001 coincided, roughly, with the collapse of profits from business travel, which had been at inflated fares during the dotcom bubble. It also coincided with strong growth by low-cost carriers such as Southwest and JetBlue. In the previous industry downturn in 1990, low-cost carriers had only a 7% market share; this time they were approaching one-third of the market, and had wrested pricing power from the traditional carriers on all but a few routes.

So how have America's traditional carriers (the big six with their hub-and-spoke networks and a legacy of unionisation and high labour costs) managed to keep aloft?

A federal hand-out of $2.5 billion in compensation for shutting airspace for four days after September 11th stopped them all going into Chapter 11 then. That might have been a better way to go. The government could have stepped in later to allow only those airlines with credible business plans to fly again.

Lessor of two evils?

Arguably, however, the most significant change in the industry since the early 1990s has been the growing role of aircraft lessors. They are led by General Electric's Commercial Aviation Services (known as GECAS) and International Lease Finance Corporation (ILFC), owned by AIG, the biggest American insurer. The GE business offers a panoply of services to airlines: not only is it the leading maker of jet engines, but also it offers aircraft finance, aircraft leases, servicing and even pilot training. “No organisation envelops airlines quite like GE,” wrote Robert Ashcroft, an analyst at UBS, in a recent research note.

Moreover, GE is the leading lessor within America. Over half of its roughly 1,350 planes are with American carriers. In contrast, ILFC leases nearly 90% of its planes to non-American carriers. At the end of 2004, GE had 150 aircraft, financed to a value of $2.6 billion, with US Airways alone.

This explains why GE has been so supportive since September 11th of stricken airlines. A nightmare for GE would be another carrier flying into Chapter 11, or one of those already there being liquidated, as either would release a flight of planes on to the market, thereby further depressing second-hand values and leasing rates.

Many of GE's leases to American carriers are so-called leveraged leases. These let the owner of an aircraft (ie, GE) defer its tax bills by writing off the cost against tax over seven years. Add in the interest on money borrowed to finance the plane and the effect is to reduce the lessor's tax payments in the early years of the lease.

Companies from beyond the usual bounds of aviation have become involved in this scheme over the years, to defer tax. A firm could, through a special-purpose entity (SPE), stump up, say, only 20% of the cost of an aircraft and yet claim 100% in tax relief—all without putting the relevant debt on to its balance sheet. When an airline goes bust, however, the deferred tax could become payable sooner than expected, and the money in the SPE could be at risk. Firms such as EDS and Walt Disney that, surprisingly, are involved in financing aircraft leases, took write-downs when US Airways and United went into Chapter 11. Whirlpool, a maker of white goods, faced accelerated tax payments. For GE, another airline bankruptcy could be a double whammy: lost or lower lease revenues and large tax payments.

A glance at GE's exposure to American carriers explains its willingness to intervene to help airlines stave off Chapter 11 and liquidation. GE was quick to help United with short-term loans when it entered Chapter 11. It has also led a syndicate that lent up to $630m on a secured basis to Delta. It is to take 24 regional jets back from Independence Air and defer the troubled fledgling carrier's lease or loan payments on other aircraft. It has agreed to contribute $140m to US Airways through loans and deferrals on lease or loan payments, and to take back 25 Boeing and Airbus planes. Counting only US Airways, ATA (a smaller carrier in Chapter 11), Aloha Airlines and United, GE's exposure is $5.4 billion. Given that GE has a further 255 aircraft placed with Continental Airlines, Northwest Airlines and America West, it could soon have to dip its hand into its deep pockets again to fend off the effects of leases going bad as another of these operating airlines goes bust. As Eric Jones of GECAS says: “We're in the business of helping our customers if we can; we do it if it makes sense for us.”

GE does hold some advantages, even as oil at around $50 a barrel threatens to push the rest of the American airline industry over the cliff in the second half of this year. A special provision of Chapter 11 gives aircraft lessors a privileged position over other creditors: they can re-possess aircraft if an airline cannot pay its outstanding lease charges within 60 days.

With air travel and airline profits recovering outside America, GE may be able to ease its troubles by placing some of its now unwanted Boeing 737s and Airbus A320s elsewhere, particularly Asia. In the first quarter of this year, GE re-deployed 18 Boeing planes in China, India and Brazil that ATA returned when it went bust. But this was a small deal. The collapse of one of the big American carriers into Chapter 11 would have far more troubling consequences for lessors.

GE is not alone in seeking to preserve the status quo by keeping airlines on life support, whether in or outside Chapter 11. A $250m loan from Airbus may have sealed the merger of US Airways and America West. Banks with credit cards tied to air miles also have a vested interest, as they do not want their customers to lose their miles. One industry estimate links 40% of Citigroup's credit-card revenues just to American Airlines' frequent-flyer programme. Tellingly, American Express has paid a $500m advance to Delta. Even so, banks are tempted to hold back some payments due to airlines, to cover the credit risk of

paid-for flights that never take off. Delta and United face the prospect of tougher terms in August and January respectively, when their credit-card contracts with the banks are up for renewal.

Beyond the support of interested and profitable parts of the aviation food-chain, and the difficulty of revising labour contracts and pension promises, there is another huge obstacle to a general shake-out that would slash capacity. For consolidation to occur in any industry, at a national or global level, there must usually be at least one strong firm able to pick up the pieces. For instance, in airlines in the early 1990s, American Airlines and United picked up the lucrative international routes of distressed PanAm and TWA.

No big airline is currently strong enough to want to pick up the scraps of bust carriers. And the industry's outlook is too bleak to attract outside investors to take on the challenge—even cash-rich private-equity investors are steering clear. The healthy low-cost airlines have no interest in assuming the legacy business model of the hub-and-spoke carriers.

Hence the miserable stalemate in which lessors and banks prop up ailing carriers in or near Chapter 11, while armies of lawyers and consultants earn huge fees working on rescue plans that never succeed. Creative destruction may be essential to healthy capitalism, but in America's air travel business the wrecker's ball has not even started to swing, yet.

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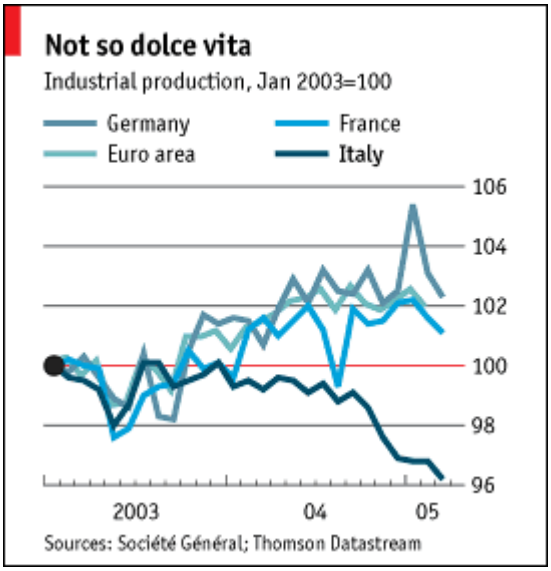
Business in Italy

In need of repair

May 19th 2005
From The Economist print edition

Italian business is in deep trouble



WHEN it rains it pours. Not only do the latest figures show that Italy is in recession, GDP having fallen by 0.5% in the first three months of this year after a similar drop in the final quarter of 2004, but also the trade balance has gone into the red for the first time since the early 1990s. On May 17th, Domenico Siniscalco, the economy minister, said Italy would probably halve its current (already halved) forecast of 1.2% growth this year.

Italy's business model has stopped working and businessmen are utterly depressed about it. The latest sign of industry's sorry state is the heavier hand of the fractious governing coalition of Silvio Berlusconi. Last week Mr Berlusconi decided to replace Vittorio Mincato, boss of Eni, the world's sixth largest oil company and Italy's only truly successful big multinational, with Paolo Scaroni, the head of Enel, a big electricity firm. Fulvio Conti, Enel's chief financial officer, will replace Mr Scaroni. The state is the controlling shareholder of both firms.

Although he is now aged 69, there was little reason to oust Mr Mincato, who is famous for his ability to say no to politicians. Both he and Mr Scaroni have done well for their firms, and shareholders other than the government would have been happy for them to stay where they were. Mr Scaroni had unfinished work in restructuring Enel. Mr Mincato wanted to shepherd Eni's investment in Kazakhstan's Kashagan field in the Caspian Sea and to decide future international expansion.

So why the reshuffle? Mr Scaroni was keen to run Eni. The government apparently did not want to risk him leaving Italy for a top job abroad—where he has prospered before. And he is closer to political circles than Mr Mincato. But Mr Scaroni's appointment is unsettling for shareholders aware that the struggling government might be tempted to use state-controlled companies to advance its political goals.

This further dents Italy's business reputation, which has already been marred by a string of disasters. The gloom started to descend in June 2002 when the departure of Paolo Cantarella, boss of Fiat, exposed the depths of the crisis in the firm's car division. Then Cirio, a food processor, defaulted on its bonds. At the end of 2003 Parmalat, Europe's biggest dairy group, almost collapsed after a huge fraud.

The troubles of Italian business are not confined to big firms, of which there are few. Small firms are the backbone of the economy. As industries in other euro-zone countries consolidated, Italy defended small operators. “We are afraid of size,” says Alberto Nagel of Mediobanca, a powerful investment bank. Many are now struggling—not least because of China's low-cost operators in the basic industries that Italy has kept going longer than most European countries. They have no cash for expansion or investment in research and development. They are also stuck with the high costs of Italian labour. Italian wages used to be lower than in other European countries. Now Italian workers are amongst the best paid and most protected in the world. Adjusting for productivity, Italian wages exceed those in Germany. The OECD says that since 2000 Italian unit labour costs have risen by a remarkable 40% relative to Germany's.

Italian entrepreneurs moan about high taxes, high social costs and red tape. Italy's income- and corporate-tax rates are among the highest in the EU, although the overall tax take as a proportion of GDP is only middling because of Italians' inclination to evade the taxman. Moreover, the tax system is extraordinarily complicated. “We need radical reforms very quickly,” says Andrea Pininfarina, vice-president of Confindustria, the employers' association. Most important, he says, is a reduction of the social costs that employers must add to wages, lower corporate taxes and less tax on mergers between small companies.

To make life a bit easier for business, Mr Siniscalco has promised to cut IRAP, an unpopular regional tax on firms. But he can ill afford lower tax revenues. Italy's budget deficit is forecast to grow from 3% of GDP in 2004 to almost 4% this year.

Yet the worst structural problem is Italy's historic strength in low-growth, mature industries, such as textiles, clothing, shoes and white goods. Manufacturing still accounts for about one-quarter of the country's economy. While Britain, for example, has made the transition to services, Italy has held on to its manufacturing base.

The cure may be even tougher than it was for Britain and is for Germany. Job cuts will mean less demand and even more unemployment. According to analysts at ABN Amro, for Italy's existing firms to become competitive again up to 500,000 factory workers would need to lose their jobs—about 10% of the manufacturing workforce. That would lift the jobless rate from 8% to about 10%. When will Italian industry bite this bullet, if the unions allow it? According to Mr Berlusconi, Italy is not in recession, but going through a phase of “stagnation”. That suggests there will be no quick recovery.

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The business of brain teasers

Do you sudoku?

May 19th 2005
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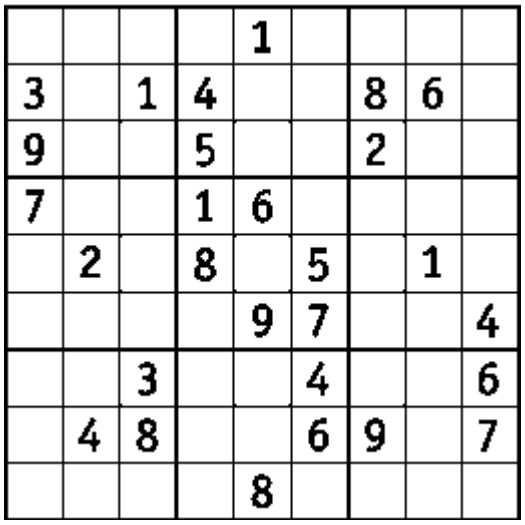
A puzzling global phenomenon



TO ITS fans, it is addictive. To the media, it is a promising money-maker. *Sudoku*, an old puzzle long popular in Japan is fast gaining popularity the world over. In Britain, a *sudoku* book is a bestseller and national newspapers are competing feverishly to publish the most, and the most fiendish, puzzles. (Last week the *Guardian* printed a board on every page of one day's features section.) Meanwhile, the puzzle is being published in newspapers from Australia to Croatia to America. The Japanese buy more than 600,000 *sudoku* magazines a month. Even the *New York Times* is considering introducing *sudoku* in its Sunday magazine, alongside its venerated crossword.

The game's appeal is that its rules are as simple as its solution is complex. On a board of nine-by-nine squares, most of them empty, players must fill in each square with a number so that each row (left to right), column (top to bottom) and block (in bold lines) contains 1 to 9. (A sample accompanies this article; the solution appears here.) Advanced versions use bigger boards or add letters from the alphabet.

Sudoku—the Japanese word combines “number” and “single”—seems perfectly suited to modern times, a puzzle for an era when people are more numerate than literate. And like globalism itself, *sudoku* transcends borders by requiring no translation.

The overall business of puzzles is hard to measure, but revenues in America from magazines, syndicated newspaper sales, books, and online and phone services are almost $200m annually. The *New York Times* earns millions of dollars a year from its crosswords and hundreds of thousands from a special phone service that provides hints. Over 30,000 people pay $35 a year for the newspaper's e-mail version, says Will Shortz, the crossword-puzzle editor.

For now, *sudoku* revenues are more modest. The person who supplies most western papers with the puzzle—Wayne Gould, a retired Hong Kong judge—does so for nothing, to promote sales of the *sudoku* software he developed, initially for fun. He says that if trends continue he may earn $1m this year from software sales and book royalties. Michael Harvey, features editor of the *Times* of London, which first published the puzzle in November, thereby setting off Britain's *sudoku* craze, claims that the grids have brought many new readers to the paper.

Puzzles have long been popular. A word square dates from 1st-century Pompeii. The crossword puzzle was launched in the *New York World* in 1913. After a compilation appeared in 1924—the first book by Simon & Schuster—the genre exploded. It is now a daily staple for millions of people worldwide.

Will *sudoku*, whose origins lie in an 18th-century Swiss mathematician's game called “Latin squares”, follow suit? Might it even prove to be the disruptive technology that kills the crossword? In the battle between left-brain and right-brain people for puzzle primacy, crossword aficionados defend their squares, noting that word puzzles offer more variety of themes, sizes and skill levels. “It is not obvious how you can vary the [*sudoku*] puzzle to make it more interesting”, says Mr Shortz. “It is what it is”.

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Hyundai Motor

A better drive

May 19th 2005 | SEOUL
From The Economist print edition

A South Korean carmaker starts making vehicles in America

AP

Cue joke about hot model

EVEN as they fall further behind their Japanese rivals, America's carmakers must worry about a new rival driving faster into their backyard: Hyundai Motor. Not long ago, the South Korean firm's cheap and unreliable imports delighted America's comedians rather than its customers. But Hyundai has rapidly improved the quality of its vehicles, which now win rave reviews. On May 20th the firm opened its first factory in America.

Hyundai's $1.1 billion plant in Montgomery, Alabama, will not be weighed down by strong unions and the legacy costs of Detroit's pension and health-care promises. This is a huge advantage, though it would count for little without the most striking aspect of Hyundai's rise. *Consumer Reports*, a popular car-shopper's guide, rated Hyundai's 2004 Sonata, a mid-sized sedan, the most reliable car in America. JD Power, another arbiter, says Hyundai's overall defect rate is the second-lowest in the industry last year—tied with Honda and just behind Toyota.

That reflects a deliberate change in strategy by a firm that used to be mostly interested in the number of cars it made. Like many South Korean firms, its goal was to crank out products to gain economies of scale and grow exports. Happily for Hyundai, that proved less ruinous than it did for the many South Korean firms that went bust due to the 1997 Asian financial crisis.

Hyundai had to cut costs dramatically, slashing 25% of its workforce. Yet it stayed in good enough shape to buy its main domestic rival, Kia. Its other rivals teamed up with foreign firms: the car business of Samsung with France's Renault, Daewoo with General Motors. That left Hyundai dominant, with a 73% market share in South Korea. But its chairman, Chung Mong-koo, reckoned that it would have to change its ways to prosper in a rapidly globalising industry. After taking over in late 1998, Mr Chung—eldest surviving son of Chung Ju-yung, founder of the Hyundai group—elevated the importance of engineers and launched a crusade to reduce defects.

It is still unclear whether this shift will be enough to secure Hyundai's place among the global elite. Despite its rise in the quality tables, it is still only the world's seventh-biggest carmaker. Yet this seems the right way to try. Compare Hyundai's American strategy with that of Japan's Mitsubishi Motors, another second-tier global player, which tried to buy American consumers with an aggressive “triple zero” financing offer—no downpayments, no interest payments and no repayments of principal in the first year. Mitsubishi soon ran up huge financing losses in America, and endured several scandals related to defects in its cars. It narrowly avoided collapse last year.

Hyundai chose to woo buyers in America by promising quality and reliability. It issued an ambitious new warranty, good for five years (ten on the engine and transmission), then challenged its engineers to back that up with flaw-proof cars. The early signs are that they have delivered. Warranty claims are less than expected. Hyundai has trimmed warranty provisions from 5.7% to just 1.8% of its revenues.

Even so, in America some customers still look down their noses at Hyundai cars. In that sense, Hyundai's dilemma is like that of other South Korean firms such as Samsung Electronics and LG Electronics, which acquired world-class technology for making flat-panel televisions and other digital products, but which also needed better marketing and lots of patience before consumers would pay a premium for their products. Indeed, John Kim, head of Hyundai Motor's design-strategy team, says he has encouraged his

people to work on special projects with designers from both electronics firms. Although mobile phones and cars are hardly similar, he is looking for colours and curves that convey a more upscale image.

Several looming strategic decisions will be crucial. The firm must decide which segments of the market to enter next. The Alabama plant will produce 300,000 Sonata sedans and Santa Fe sports-utility vehicles a year—two segments in which Hyundai has done well. The firm may also make more use of the Kia brand. Since the merger, the two firms have focused on building vehicles that share common platforms and on cutting costs. Now Hyundai plans to use Kia as an alternative brand, perhaps by giving it models with a younger, sportier image.

After that, the options get trickier. Pick-up trucks are one possibility, but American buyers tend to be loyal to certain brands—especially Detroit ones. Hyundai has so far given hybrid-engine cars a miss. That leaves luxury cars. Hyundai's managers have hinted that more upmarket products could appear within a few years. Luxury cars, however, will require yet another big leap in quality—not least because their buyers are especially demanding. Hyundai has learned the hard way that car buyers' expectations change slowly. So if it does decide to cross over into the luxury market, it will need plenty of patience.

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Business in Argentina

Getting serious

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Will the Argentine government pay what it owes foreign firms?

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UNDER President Néstor Kirchner, Argentina has taken up the slogan “a serious country”. But more than three years after its devastating financial crisis, it has made few efforts to make amends with foreign firms—not least those in its utilities and energy sectors. After investing over $50 billion in new infrastructure and acquisitions in the 1990s, they were hit hard during the crash: the government converted their dollar-denominated revenues into pesos and has kept them frozen ever since, despite wholesale inflation of nearly 80%. Many companies abandoned the country, perhaps for good.

Unlike foreign holders of Argentine government bonds, however, who lent to Argentina with no collateral and had to accept the government's stingy restructuring offer, the foreign firms had some negotiating leverage. Their contracts with the government gave them the right to arbitration at the World Bank-affiliated International Centre for the Settlement of Investment Disputes (ICSID). Some 35 foreign firms have filed claims against Argentina there, seeking in total nearly $20 billion (11% of Argentina's GDP). Last week, ICSID gave its first post-crisis verdict on Argentina: a $133m award to an American firm, CMS Energy, which owns shares in a gas transport firm whose rates were converted to pesos and frozen. The value of CMS Energy's stake is barely one-twentieth of what it was.

Argentina's justice minister, Horacio Rosatti, argues that ICSID has no jurisdiction over Argentina, whose government cannot comply with its rulings if the Supreme Court finds them incompatible with the country's constitution. The economy minister, Roberto Lavagna, called for an appeal to the Supreme Court this week.

But Argentina has signed a bilateral treaty with America guaranteeing to fulfil ICSID awards to American firms. Failure to pay would breach the treaty and irritate America, which Mr Kirchner has so far tried not to provoke. Non-compliance would ensure that foreign firms stay out of Argentina, just as its economy is hitting capacity constraints and desperately needs capital. No country has yet defaulted on an ICSID judgment.

Currently Argentina's government does not have the cash to pay anything close to the sums that ICSID is likely to award foreign firms. CMS won about half of what it sought. If other claims are as successful, Argentina could face around $10 billion in damages, compared with overall central government discretionary spending of just $14 billion in 2004. Raising taxes would be tricky, as the tax burden is already at an historic high.

The only viable option, it would seem, is to negotiate. Most of the firms simply want rate increases to recover some of their investment and service their newly restructured debt—nearly all of them defaulted on their obligations in the crisis. A deal would also attract much-needed investment to Argentina's energy sector. But it would require Mr Kirchner, who revels in confrontations with politically unpopular foreign businesses, publicly to buckle to their pressure—while raising voters' utility bills in the process. “He may be a slave to his own words,” says Daniel Montamat, a former national energy secretary. “Any movement to revise his position could be seen as an act of weakness.”

The president, whose Peronist party faces elections this October, has vowed not to let the firms raise prices for residential users, and could hardly back down from this mid-campaign. But ICSID procedures give Argentina four months to file an appeal, thereby delaying any final payment or negotiation until after this year's legislative elections—and perhaps well beyond it. If Mr Kirchner's party wins a big majority, as expected, he may then have the political capital to allow some further hikes in energy costs, perhaps in

conjunction with subsidies for low-income users.

As long as energy prices stay at their current levels, investment in the sector will remain sparse. And as the government resumes servicing its debts, it will have less money available to buy fuel from abroad—it spent $700m in 2004 to increase energy supplies, mostly through imports. If economic growth pumps up demand for energy, Mr Kirchner risks politically embarrassing power shortages. In that sense, his personal political interest—he is up for re-election in 2007—may actually be aligned with those of the foreign investors he seeks to defy. Argentines hoping for reliable electricity, gas, and water services must hope he sees it that way.

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Software piracy

BSA or just BS?

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Software theft is bad; so is misstating the evidence

IT SOUNDS too bad to be true; but, then, it might not be true. Up to 35% of all PC software installed in 2004 was pirated, resulting in a staggering $33 billion loss to the industry, according to an annual study released this week by the Business Software Alliance (BSA), a trade association and lobby group.

Such jaw-dropping figures are regularly cited in government documents and used to justify new laws and tough penalties for pirates—this month in Britain, for example, two people convicted of piracy got lengthy prison sentences, even though they had not sought to earn money. The BSA provided its data. The judge chose to describe the effects of piracy as nothing less than “catastrophic”.

But while the losses due to software copyright violations are large and serious, the crime is certainly not as costly as the BSA portrays. The association's figures rely on sample data that may not be representative, assumptions about the average amount of software on PCs and, for some countries, guesses rather than hard data. Moreover, the figures are presented in an exaggerated way by the BSA and International Data Corporation (IDC), a research firm that conducts the study. They dubiously presume that each piece of software pirated equals a direct loss of revenue to software firms.

To derive its piracy rate, IDC estimates the average amount of software that is installed on a PC per country, using data from surveys, interviews and other studies. That figure is then reduced by the known quantity of software sold per country—a calculation in which IDC specialises. The result: a (supposed) amount of piracy per country. Multiplying that figure by the revenue from legitimate sales thus yields the retail value of the unpaid-for software. This, IDC and BSA claim, equals the amount of lost revenue.

The problem is that the economic impact of global software piracy is far harder to calculate. Some academics have shown that some piracy actually increases software sales, by introducing products to people who would not otherwise become customers. Indeed, Bill Gates chirped in the 1990s that piracy in China was useful to Microsoft, because once the nation was hooked, the software giant would eventually figure out a way to monetise the trend. (Lately Microsoft has kept quiet on this issue.)

The BSA's bold claims are surprising, given that last year the group was severely criticised for inflating its figures to suit its political aims. “Absurd on its face” and “patently obscene” is how Gary Shapiro, boss of the Consumer Electronics Association, another lobby group, describes the new ranking.

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Nuclear power

British dreams

May 19th 2005
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Britain's nuclear enthusiasts see hope in Tony Blair's re-election

Get article background

WHEN the British government privatised its nuclear-power arm, British Energy, in 1996, it launched the shares on an eager market at £2.03. By 1999 they were well over £7. Then power prices crashed; a state bail-out left the company just afloat, but its shares were almost worthless. After a one-for-fifty consolidation, they rejoined the London market this January at about £2.50. Within weeks the firm was reporting nine-month losses of £349m (about $645m), even though each megawatt-hour from its eight plants had fetched some 25% more than they did a year earlier.

So the shares have crashed again? On the contrary. On May 12th they briefly hit £3.35. Why? On May 5th, a general election returned Tony Blair to power—and gave hope to Britain's (rare) nuclear enthusiasts.

Indeed, to enthusiasts throughout western Europe. Only one new nuclear plant has got the go-ahead in the European Union since 1991, that approved by Finland three years ago. Meanwhile, Russia is building six new reactors at existing sites, with 19 more planned, some in new locations. Even France, 75% of whose electricity is nuclear (as against 20% in Britain), completed its last plant in 1999 and has no definite new projects, though state-owned Framatome, in which Siemens now has a stake, is to build the Finnish plant, using a new pressurised-water (PWR) design, which it is eager to sell elsewhere (not least, in China).

In Britain, the nuclear industry's fresh hopes rest on the government's dream of achieving a 20% cut in carbon emissions by 2010; and the prospect that by 2020 some 70% of British electricity will come from natural gas, nearly all imported from countries not without significant political risk. Wind farms may help a little, but today's ageing nuclear plants are all due for closure by the early 2020s. If they are not replaced, the dream is destined to be exactly that. So, ask some in the industry, with Mr Blair re-elected—and said to be pro-nuclear—may we proceed?

It will come as no surprise if Mr Blair's government soon approves extending the life of existing British nuclear-power plants. But who will invest in new ones? Construction could cost over $2.5m per megawatt of capacity—about four times as much as a natural gas plant. That could fall sharply (and in South Korea did) if several plants were built; the Russians talk of, eventually, $1m per megawatt. But the time-scales are dauntingly long: at the very least seven years, even if Britain's creaking planning process could be speeded up.

And output prices are not merely uncertain so far ahead, they can also vary with extreme rapidity under the pricing scheme in force in most of Britain since 2001. That is bad news for nuclear plants, which cannot be switched off and on easily. It was prices and price volatility together that brought British Energy to its knees. Then there are waste costs. And decommissioning costs, albeit far off, and currently to be borne by the government. But who knows what future governments will think decades from now?

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Face value

Red devil

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AP

Can Malcolm Glazer, Manchester United's unpopular new American owner, turn a profit in European soccer?

A BITTER atmosphere threatens to spoil Saturday's English FA Cup Final—a showpiece that remains to many fans soccer's equivalent of American football's Super Bowl and the baseball World Series. Fans of Manchester United—the "red devils"—who play fierce rivals Arsenal in the final, plan to abandon their usual red scarves and joyful (at least when they are winning) singing in favour of black flags and protest. The focus of their ire is Malcolm Glazer, an American shopping-mall tycoon and owner of the Tampa Bay Buccaneers, an American football team. This week Mr Glazer declared victory in his long battle to buy United. Death threats have been made against him.

Mr Glazer's main offence seems to be that he is a businessman who intends to run United as a business. That is not what owners of British sports teams—or, indeed, of teams in most of the world—are meant to do. Businessmen and other wealthy folk, even foreigners, are welcome as owners—but only if they plan to put money into a team, not take it out.

So what if by so doing they are merely trying to boost a flagging public image—as Harrods owner Mohamed Al Fayed and, earlier, the late Robert Maxwell, did by buying Fulham and Oxford United, respectively? Or if their aim is to cement a valuable friendship, as the Libyan dictator, Muammar Qaddafi's, 2002 investment in Italy's Juventus did with the team's main owner, the Agnelli family? Better, though, if he or she is a lifelong fan whose dearest wish is to spend money to help the team they love. A star of the English soccer season now ending has been Norwich City's main shareholder, Delia Smith, a celebrity cook, who made headlines by delivering an alcohol-assisted speech during a half-time interval urging fans to get behind the beloved team that she once rescued from the brink of bankruptcy. A more pertinent example for Manchester United fans is Chelsea's devoted owner, Roman Abramovich, a Russian oil billionaire, who has spent a large chunk of his controversially gotten gains to assemble the team that easily won this season's English Premiership title. His unprecedented redistribution of money from the people of an economically struggling nation to a handful of wealthy foreign sport-stars bothered fans of Chelsea not one bit.

If United supporters believed that Mr Glazer would follow Mr Abramovich's generous lead, there would be few protests. But they have not been reassured by one of 76-year-old Mr Glazer's five sons, Joel, who

will oversee day-to-day affairs at United. He has said that his family are “avid Manchester United fans” who want the club to “achieve even greater success”.

Their scepticism can be attributed in large part to the fact that they view Mr Glazer and sons as typical profit-driven American capitalists, prone to do ghastly capitalistic things such as raise ticket prices—as they have done in Tampa at the Bucs. Indeed, as United tickets are now underpriced (rampant ticket-touting surely indicates unmet demand), he can and arguably should raise prices. If some fans then boycott United games, as they say they will, there are lots more where they came from—or will be so long as United remains successful. That, if only for profit-maximising reasons, will surely be a priority for Mr Glazer. The Bucs, which he bought in 1995, won the Super Bowl in 2003.

Likewise, it will be no surprise if the naming rights to United's Old Trafford home are sold to a sponsor; Arsenal recently took $100m over 15 years for naming its new stadium after Emirates, an airline. Mr Glazer will also bring marketing nous honed at Tampa—Bucs fans could not live without the comprehensive cheerleader section of the team's website, for instance. But it will not be easy to improve on United's existing merchandising efforts to its estimated 75m fans globally—judging by the club megastore's extensive range of replica shirts and other themed items (Manchester United curtains, anyone?).

In the red

True, United fans may have some reason to worry about the debt that Mr Glazer is piling on to the club's hitherto healthy balance sheet. Exactly how much of a purchase price that values United at £790m ($1.5 billion) will be paid by borrowing is unclear. His use of a high-risk financing technique known as a “PIK” (pay in kind) loan that is now worryingly popular in private-equity deals is not encouraging. Nor is the example of Leeds United, a team that only a few years ago was briefly among the best in Europe but has since been relegated amid a financial crisis brought on by excessive debt and whizzy financing techniques such as making asset-backed securities of its top players. The trigger for this disaster was the failure of Leeds to qualify for the hugely lucrative annual Europe-wide Champions League—a fate that Mr Glazer must ensure never befalls his new team.

To boost revenues, Mr Glazer is expected to try to end joint negotiation of television rights by the top English teams that play in the Premiership, instead negotiating separately the right to screen United games. That sort of rampant individualism, after all, is what American capitalists are famous for. In fact, American team owners tend to profit by suppressing, to some extent, their individualism, points out Stefan Szymanski, co-author of “National Pastime”, a superb new book that compares the economics of the sport business in different countries. American sports leagues—above all the National Football League, in which the Bucs play—tend to be cartels, with fewer teams than there would be in a free market, protected by the absence of relegation, and often using socialistic practices such as salary limits for players and a centralised sharing out of young players to stop any team becoming too hopeless. As the Premiership evolves, and, above all, as Europe's top soccer teams, with United to the fore, debate how to take Europe-wide competition to the next even more profitable level, Mr Glazer's knowledge of American sport's anti-competitive collectivism may prove priceless.

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Sarbanes-Oxley

A price worth paying?

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From The Economist print edition

America's response to Enron and other scandals was the Sarbanes-Oxley law. It is costing plenty—but is it working?

THE Sarbanes-Oxley statute, which the United States enacted in an atmosphere of extraordinary agitation in 2002, is one of the most influential—and controversial—pieces of corporate legislation ever to have hit a statute book. Its original aim, on the face of it, was modest: to improve the accountability of managers to shareholders, and hence to calm the raging crisis of confidence in American capitalism aroused by the scandals at Enron, WorldCom and other companies. The law's methods, however, were anything but modest, and its implications, for good or ill, are going to be far-reaching.

Since the new accounting rules and regulatory infrastructure that goes with them are still bedding in, it is too soon for a definitive judgment. (That time may never come, in fact: academics are still arguing about the pros and cons of the Glass-Steagall act of 1933, a similarly momentous initiative.) It is early days for academic appraisals, but the ones that have been ventured so far tend to the view that costs will exceed benefits. Meanwhile, many of America's businessmen are deeply unhappy, and with reason: the initial costs of the new law have been bigger than expected. And it can be argued that, when it comes to repairing American corporate governance, the law anyway addresses symptoms more than causes.

With time, no doubt, the law's balance of costs and benefits will improve significantly: some of the costs have been once-and-for-all. Right now, though, the balance looks pretty unfavourable.

Alan Greenspan, chairman of the Federal Reserve, spoke up in defence of the statute this week. It was faint praise. He said he was surprised that a law which had been passed so rapidly had worked as well as it has—less of an endorsement than it first seemed, since laws dealing with issues as complex as these and passed as “rapidly” as was Sarbanes-Oxley can normally be expected to fail abjectly.

Mr Greenspan also noted that the law will be fine-tuned as experience accumulates. Quite so. Next day, the Securities and Exchange Commission (SEC), along with the Public Company Accounting Oversight Board (PCAOB, created by the law), told accountants that they were being too inflexible, “overly cautious” and “mechanical” in interpreting the statute. They called for the exercise of greater discretion—something which, three years ago, the architects of the statute had seemed to frown on. Whether good or bad, therefore, SOX, as it has become known, is by no means as yet a settled regime, but a work in progress.

Its initial provisions are wide-ranging. As well as establishing the accounting-oversight board, the statute prohibits audit firms from doing a variety of non-audit work for their clients (in order to address some obvious conflicts of interest). It requires companies to establish independent audit committees. It forbids company loans to company executives. It calls on top executives to certify company accounts. And it extends protection for whistleblowers: no company may “discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee” because of any lawful provision of information about suspected fraud. (Tip-offs from insiders are by far the most common method of detecting fraud.)

The law's most complained-of provision, however, is its section 404. This makes managers responsible for maintaining an “adequate internal control structure and procedures for financial reporting”; and demands that companies' auditors “attest” to the management's assessment of these controls and disclose any “material weaknesses”. Draconian new criminal penalties await transgressors.

Worse than the disease?

The cost of all this is steep. According to one study that has attracted a lot of attention, the net private cost amounts to $1.4 trillion. This astonishing figure comes from a paper by Ivy Xiying Zhang of the William E. Simon Graduate School of Business Administration at the University of Rochester. It is an econometric estimate of “the loss in total market value around the most significant legislative events”—ie, the costs minus the benefits as perceived by the stockmarket as the new rules were enacted. In principle, this ought to reflect all the anticipated costs and benefits, direct and indirect, that impinge on company values. If this number were true, SOX would have to prevent an awful lot of unforeseen losses due to fraud before it could be judged a good buy.

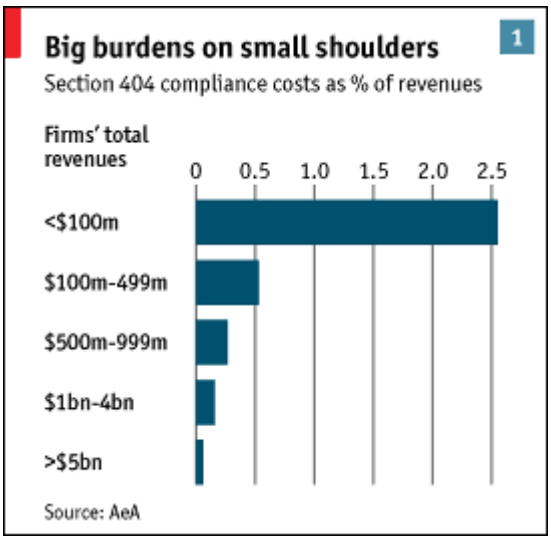
To help see whether the estimate is plausible, can any more light be shed on different categories of costs? Direct costs are much the easiest to measure. A survey by the FEI, an association of top financial executives, found that companies paid an average of $2.4m more for their audits last year than they had anticipated (and far more than the statute's designers had envisaged). Deloitte, a big accounting firm, has said that large firms have on average spent nearly 70,000 additional man-hours complying with the new law.

This underlines a notable unintended consequence of the legislation: it has provided a bonanza for accountants and auditors—a profession thought to be much at fault in the scandals that inspired the law, and which the statute sought to rein in and supervise. The demand for accountants has surged to such an extent that the PCAOB has had to curb its own growth plans. In January, Thomas Hohman, the agency's CFO, told *Accounting Today*, “We would like more [experienced auditors], but we recognise this is a very tight employment market.” This shortage of personnel in a profession on whose shoulders the law has placed heavy new responsibilities is one of the uncertainties hanging over the act's future effectiveness.

Already reduced in number by consolidation and the demise of Arthur Andersen, the big accounting firms are now known more often as the Final Four than the Big Four, since any further reduction is thought unlikely. Section 701 of the new law instructed the General Accounting Office (GAO), the investigative arm of Congress, to look into the concentration of the accounting industry and its impact. The GAO, in its findings published in July 2003, said that there was a potentially unhealthy degree of concentration.

The Final Four—Ernst & Young, Deloitte, PricewaterhouseCoopers (PwC) and KPMG—audit 97% of all large companies in America. The GAO also noted that smaller accounting firms face “significant barriers to entry” and that “market forces are not likely to result in the expansion of the Big Four”. The American Electronics Association (AeA), which represents 2,500 companies and is an outspoken critic of the law, maintains that lack of competition “is significantly increasing the costs of section 404 certification”.

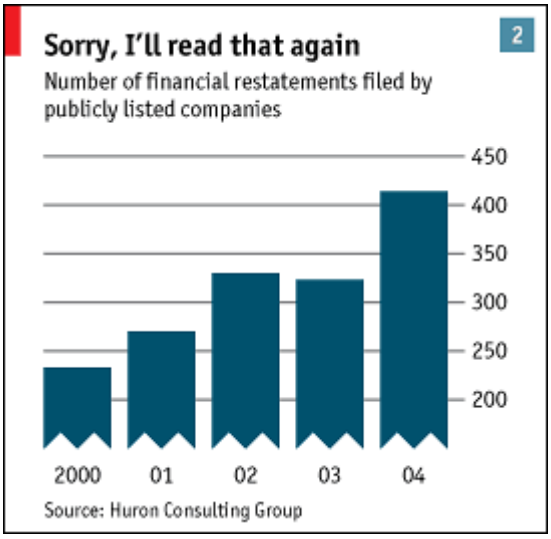
Last year a number of big companies switched to smaller auditors. AuditAnalytics.com, an online research company, reckons that the big firms lost more clients last year than they gained. After 25 years with PwC, Scientific Technologies, an instrument-maker with a turnover of $58m, switched to BDO, the largest of the pack pursuing the Final Four auditors. The company reckoned that the switch could cut its audit fees by 25-50%. Many firms have seen much bigger increases than that. According to AuditAnalytics.com, the fees paid by Advanced Micro Devices more than trebled last year. Bristol-Myers Squibb paid fees of $27.4m in 2004, more than twice as much as the year before.



The burden on smaller firms is a particular concern to the AeA and others. Regulators have already been obliged to bend the rules for them. Smaller companies were given extra time to file their accounts this year, the first in which they had to include section 404 reports. More such flexibility is likely in future. In December last year, the SEC set up a panel to review the act's impact on smaller companies.

The auditors emphasise that a good deal of the cost arises from a one-off learning process involved in first adopting the act's requirements. Samuel DiPiazza, chief executive of PwC and an enthusiastic advocate of the new law, says that the costs of applying section 404 were exceptional in the first year and will fall in due course. Eugene O'Kelly, the head of KPMG's American business, has said he reckons auditors' attestation fees related to section 404 should fall by 15-25% this year.

Less visible costs have also been incurred. Far harder to measure, these may be even larger than the direct costs—and would certainly have to be, if the total, net of private benefits, were ever to amount to anything like $1.4 trillion. Some non-American companies have threatened not to list in New York because of the cost of the legislation; others that have recently delisted from an American stock exchange are said to have done so partly because of Sarbanes-Oxley; and some 20% of public companies in a study by Foley & Lardner, a law firm, said that they were considering going private to avoid the costs of the act. It would be regrettable if a law intended to improve the quantity and quality of financial information available to investors led many companies to seek relatively unregulated forms or jurisdictions—but that does seem to be happening.



Another hidden cost which many business leaders complain of is the effect which the law will have in discouraging risk. Steps to discourage risks of the kind taken by Enron might seem entirely warranted—indeed, you might argue, that was the whole point of the law—but many of the statute's critics say that in threatening (as they see it) to criminalise ordinary business mistakes it goes too far. Small firms, put at a particular disadvantage by the added regulatory burden, also tend to be more inclined than big ones to take risks.

Be patient

What then of the benefits? PwC told the SEC, “The costs are tangible, quantifiable and immediate, while many of the benefits are intangible, harder to quantify and longer term.” Donald Nicolaisen, chief accountant of the SEC, echoed the sentiment: “I suspect that the costs are not easy to estimate,” he told an audience in October 2004, “but I know that it is even tougher to quantify the benefits.”

Michael Oxley, co-sponsor of the law, himself said earlier this year: “How can you measure the value of knowing that company books are sounder than they were before?” The chairman of the House of Representatives' financial-services committee acknowledged that the act, named after him and Senator Paul Sarbanes, imposes real costs on firms. It is, he said, “an investment for the future”.

This year, for the first time, companies have been filing the reports required by section 404. Fewer large companies are reporting problems with their internal controls than had been expected. Moody's, a rating agency, says that about 5% of the companies that it rates had reported material weaknesses up to April 1st this year, compared with the 10-20% that the market had been expecting. That figure might rise as smaller companies, which have been given an extension to their reporting deadline, start to file. There is also a fear that there may be a disproportionate number of problems with companies (typically retailers) whose financial year closed at the end of January.

Moody's says that the most serious control problems lie not with the reported delinquents, but with the late filers—the companies that were unable to get their reports to the SEC on time. This group includes notorious cases such as AIG and Fannie Mae, but also Delphi, a big car-parts manufacturer with close links to General Motors that has said it needs to restate its accounts back to 2001, and the Interpublic group of advertising agencies.

Moody's, a front-line consumer of financial reports, takes a positive view of the impact of section 404. In April it wrote, “We perceive that companies are strengthening their accounting controls and investing in the infrastructure needed to support quality financial reporting.” In the past, companies used to rely on their auditors for advice on many of their more complicated accounting issues. “Many companies,” says Huron, a consulting firm, in its latest review of financial reporting, “are just now realising how much they used to depend on their auditor, and that the burden is on them to adjust to a new reality.”

Because of Sarbanes-Oxley, firms now have to make accounting decisions for themselves. This has, says Moody's, “inspired companies to reinvest in accounting personnel”. It has also spurred many of them to look more closely at their business processes, the fountainhead of their raw accounting data.

At a discussion in April chaired by the SEC, the act was said to have had a “chilling effect” on the relationship between managers and auditors. A good thing too, you might say. Many of the problems at Enron remained hidden because the relationships between its managers and its auditors, Arthur Andersen, were far too warm, with accounting personnel even switching between the two organisations. A little chilling might be just what was needed. Big chunks of the act were explicitly intended to keep a distance between the two parties. Hence the limits on other services that auditors can provide to their audit clients, and the requirement that audit committees (the interface with the auditing profession) consist of independent directors receiving no other form of compensation from the company.

But will the law really help reduce financial fraud in corporate America—and by enough to justify its formidable costs? It might. It has certainly been a salutary reminder to corporate leaders that they are paid a lot of money because they are responsible for a lot of things—in particular, for ensuring that their companies' accounts provide investors with as honest a view as possible of the state of their organisation. At the end of April, Dennis Nally, the chairman of PwC (admittedly not a disinterested observer), said that he believes, over time, America will see “fewer incidents involving accounting fraud”.

Time will tell. But it is also possible that Sarbanes-Oxley will come to be seen as both too much and too little. In due course it might well be argued that the act was right to make the relationship between auditors and their “clients” more distanced and adversarial—but then went far beyond what was necessary in that respect by, among other things, imposing responsibilities on CEOs that they are not, in fact, in a position to discharge. At the same time, this argument might go, the underlying failures at Enron and the others were not accounting irregularities as such but other kinds of corporate-governance failure altogether, not even addressed by Sarbanes-Oxley. The first great post-SOX corporate scandal—you can bet there will be one—should be very revealing.

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Adecco

Teething troubles

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One company's experience of Sarbanes-Oxley

ADECCO is the world's biggest temp agency, with 5,000 offices in 58 countries and some 700,000 temporary employees on its books at any one time. Its headquarters are split between Lausanne and New York, and it is listed in both Switzerland and America. At the end of 2003 its auditors, Ernst & Young, said they were not prepared to sign its accounts because there were material weaknesses. A quoted company ignores such a pronouncement at its peril. Adecco declared immediately—as it is obliged to do by stock-exchange rules—that there would be a delay in filing its accounts. The market assumed the worst and Adecco's share price fell sharply.

For six months, as many as 160 auditors crawled over the company's books. Ludicrously, they checked every single transaction of more than $100 (in a company with an annual turnover of more than $20 billion). They soon determined there was no reason to suspect misappropriation or fraud. The problem, they said, was that the company's internal controls were weak, and the audit trail was not strong enough.

John Bowmer, Adecco's former chairman who came out of retirement to oversee the re-auditing, complains about the way in which, under such a process, the auditors are in complete control. There is no appeal and no turning elsewhere for a second opinion. It is, he says, “a kangaroo court”. Many of the accountants working on Adecco's audit were former employees of Arthur Andersen, who were even more apprehensive than their colleagues of the Public Company Accounting Oversight Board. At that time none of them knew quite what the new overseer of their industry would expect and how it would operate.

At one stage there were three sets of lawyers employed to cover the accountants' backs, checking that their work would not lead to lawsuits after the event. The bills of 15 different law firms, pricing their services at rates of up to $800 an hour, were paid by Adecco. They were, says Mr Bowmer, “charging like raging bulls. It was a fee fest.”

The whole process cost Adecco $120m. By the time the auditors did sign the accounts, a decade's worth of auditing had been carried out in less than 12 months. The company's audit fee for 2004 was a mere €18.7m ($23.2m), in a year when fees for many big companies rose by over 50% because of SOX.

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Revaluing China's currency

What's it worth?

May 19th 2005 | HONG KONG AND WASHINGTON, DC
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AP

Don't expect a big change in China's exchange-rate policy—or much effect on the world economy

Get article background

SPECULATION about China's currency has reached fever pitch. The combination of rising political pressure from America and technical adjustments to China's foreign-exchange trading system has convinced investors that the Chinese authorities are about to end the yuan's decade-old peg at around 8.28 to the dollar.

In a report published on May 17th, America's Treasury Department stopped short of accusing China of currency manipulation, but made clear that sterner stuff could follow, were the peg not changed soon. A day later, in a long-scheduled move, a new foreign-exchange trading system began, allowing Chinese banks to deal in eight currency pairs (seven involving the dollar, plus euro-yen trades). This had been rumoured to be a possible moment to ditch the peg.

It was not. May 18th passed with the peg intact. The speculation, though, goes on. The “shadow” yuan (traded offshore via so-called non-deliverable forward contracts) has been brushing new highs (see chart). And currency traders have found new potential catalysts for revaluation. In July, Hu Jintao, China's president, may attend the G8 summit in Britain. In September he is to visit America. Both trips might be more congenial if China had adjusted its currency.

In fact, diplomatic niceties matter less to the Chinese authorities than does national pride. They do not want to be seen to bow to foreign pressure about the yuan, and are loth to reward speculators. Both factors suggest that China will try to move when markets and foreign governments least expect it.

A little, or a lot?

In any case, any shift in the yuan's peg may prove underwhelming. Though the details differ, most economists reckon China has three broad options, which might be labelled mini, midi and maxi. The least ambitious would be a small widening of the yuan's trading bands against the dollar or a gradual shift

from the strict dollar peg to one based on a trade-weighted basket of currencies. Jonathan Anderson, chief regional economist at UBS in Hong Kong, reckons there is an 85% chance the Chinese will simply do that. Economists at Goldman Sachs, in contrast, put the chances of such a mini-reform at merely 5%.

A midi-reform would combine a widening of the currency bands or shift to a basket with a small revaluation. Mr Anderson estimates the chances of this, with a step revaluation of between 5% and 7%, at about one in seven. The Goldman team reckons there is a 60% chance of a 3-5% revaluation in the coming weeks, accompanied by a shift to a wider band. J.P. Morgan's boffins expect a move to a tightly managed float, beginning with a widening of the currency band to 1-1.5% either side of its central value and allowing a 7% appreciation by the end of the year.

The maxi-reform—the one with the biggest short-term economic impact—is a large, one-off revaluation of the yuan, of say 15-25%, followed by either a managed float or a repegging to the dollar. Mr Anderson believes there is only a 1% chance of a big appreciation and a managed float. The economists at Goldman, though, say there is a one-in-four chance that the Chinese might simply repeg the yuan to the dollar at a rate 10% or more higher than now.

Plainly, expert opinion is all over the place. Judging by the shadow yuan, financial markets reflect a sort of average of the divergent views, and are betting on a 6% appreciation within a year. The uncertainties come from the tension between China's concern for stability and the risk that a small shift in the yuan would create more problems than it solved.

Officials in Beijing are acutely worried about the impact a large revaluation might have on exports and employment. On May 10th Zhai Zhihong, an official at China's National Bureau of Statistics, said export growth could slow to 10% this year if the yuan strengthened by 3-5% and exports could drop if the currency rose by 15% or more. That looks improbable, given the high import-intensity of China's export industries. J.P. Morgan, for instance, estimates that a 10% appreciation in the next year would slow China's export growth to a still breakneck 18%.

For Chinese policymakers the main advantage of a big move would be an end to the inflows of “hot” money seeking to profit from a stronger yuan; a small move might simply feed speculative fervour. China's foreign-currency reserves of $660 billion are rising by $17 billion or so a month. To mop up the liquidity created from buying these reserves, China's central bank has to issue ever more domestic-currency bonds. With more than 1 trillion yuan of these bonds now outstanding, the country's commercial banks are becoming more reluctant to buy them. China's central bankers do not want to oversee a currency adjustment that makes the problem worse.

On balance, incrementalism is likely to win out. That implies that the eventual change will be less monumental for the world economy than many expect. China's growth might slow a bit. Other Asian countries could let their currencies rise. Some Asian currencies, indeed, have already risen in anticipation of a dearer yuan. On May 18th, Hong Kong widened the band within which its currency may move against the dollar, in order to make it less attractive to speculators betting on a revaluation of the yuan.

Further, a small Chinese revaluation would have virtually no impact on America's vast external deficit. China's share of America's imports is around 10%, so even a 10% appreciation would reduce the dollar's

trade-weighted value by only 1%. Were China's move followed by the rest of Asia, the dollar's value would fall by something closer to 4%. But even that would do little to close America's $600 billion-plus current-account gap.

More uncertain is how a Chinese currency shift would affect asset prices, particularly of American bonds. Some worry that a rising yuan could send American interest rates up by as much as two percentage points. That sounds overblown. Given China's current-account surplus and its desire for gradualism, the central bank is highly unlikely to stop buying dollars altogether. Although there is evidence that the world's central banks are slowing their purchases of American Treasury bonds and notes (see article), that probably reflects strong private demand.

So, short of panic or crass political handling, an appreciation of the yuan will not send the world economy into a tailspin. Then again, nor is it the answer to global imbalances, notably America's current-account deficit. It will, however, be a step in the right direction.

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China's banks

Foreign fillip

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China Construction Bank is at last securing international investors

Get article background

BANK OF AMERICA (BofA) has signed a memorandum of understanding to take a strategic stake in China Construction Bank (CCB), one of China's big four state lenders, *The Economist* has learned. America's second-biggest bank (by market capitalisation) is negotiating the purchase of around 5% for $1.5 billion-2 billion. Sources say that Temasek, the Singapore government's investment agency, is also in advanced discussions with CCB over a similar stake. The Chinese bank is still talking to other banks and private-equity firms.

These hotly awaited deals would make CCB the first of the big four to attract a foreign strategic investor. CCB and Bank of China (BoC), another of the group, have been vying to attract partners ahead of international stockmarket listings planned for this year. The world's banks are attracted by China's huge potential, but have been reluctant to invest much, given the local banks' weighty non-performing loans (NPLs), poor corporate governance and opaque accounts. BofA and Temasek are unlikely to secure more than one or two board seats in return for their investment. “How much influence can they really have when they don't control the board?” asks a senior Chinese banker.

Although the talks between CCB and its investors could still fall apart, their success would represent a big vote of confidence in the bank, making an initial public offering in 2005 much more likely. In total, foreign investors are not allowed to own more than 25% of a Chinese bank, with a single investor limited to 20%. CCB's flotation, planned to take place in Hong Kong and Shanghai and expected to raise $4 billion-5 billion, would involve close to 15% of its shares, valuing the group at around $30 billion, say people close to the talks. Although that valuation is below initial expectations of $40 billion set last year, it is consistent with the sharp subsequent decline in China's domestic stockmarket. A string of banking scandals has not helped. CCB's chairman, Zhang Enzhao, resigned in March amid allegations that he had accepted bribes.

BoC has been talking to several banks, including Royal Bank of Scotland (RBS), UBS, J.P. Morgan and Deutsche Bank. Liu Mingkang, head of the China Banking Regulatory Commission (CBRC), the chief banking watchdog, said on May 18th that BoC was close to signing a memorandum of its own. A source close to the bank suggests RBS is the leading candidate. However, BoC appears to be falling behind CCB and its listing may be delayed until 2006.

Kenneth Lewis, BofA's chief executive, has said that he is interested in investing $1 billion-2 billion in a Chinese bank as part of a broader, strategic partnership that could include, say, a credit-card joint-venture on the mainland. Citigroup, which is advising CCB, was thought to have agreed to invest in return for the IPO mandate, but now appears to be backtracking.

Temasek has long seen financial services in Asia as a prime means of expansion. The agency controls DBS, one of Singapore's biggest banks, and has invested in banks in Indonesia, South Korea and India. Temasek has also been in talks to buy a stake in Minsheng Bank, one of China's smaller, private lenders.

Both CCB and BoC are undergoing a thorough restructuring. Between them they received $45 billion from the government last year to clean up their accounts. Guo Shuqing, CCB's new chairman, said this week that his bank's capital-adequacy ratio had reached 12%, while its NPLs were less than 4% of its assets.

Mr Guo said he was confident that CCB could complete its flotation this year. But two smaller banks are likely to beat him to market. The Bank of Communications, the fifth-biggest lender, in which HSBC has a

19.9% holding, and Minsheng Bank are on track to become the first Chinese banks to list their shares overseas this summer.

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American Treasury bonds

Among the missing

May 19th 2005
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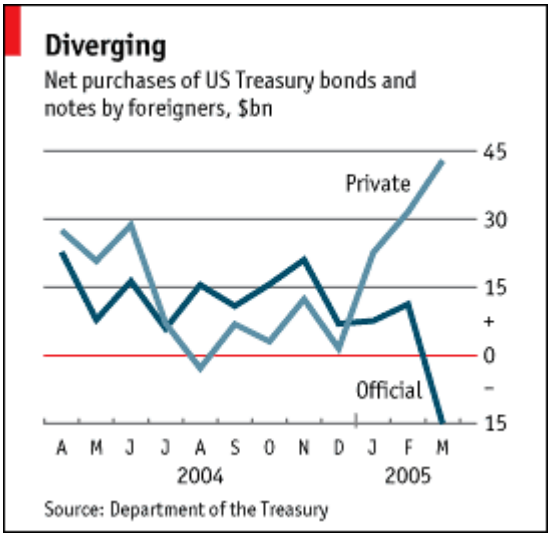
Foreign central banks have gone off Treasuries—for now



IN MARCH, currency and bond markets stumbled on reports that the mainly Asian central banks that had long been stalwart buyers of America's growing debt were planning in future to diversify their reserves. In May, Treasury bonds strengthened and the dollar barely trembled, despite news confirming that foreign central bankers had indeed done just that. Even the stockmarket had a good few days. Doesn't it matter any more?

For the first time since August 2003, in March foreign central banks were net sellers of Treasury bonds and notes, according to American government data released on May 16th. They parted with a net $15 billion-worth. As the chart shows, private investors (including a number of hedge funds domiciled in the Caribbean) rode to the rescue, increasing their purchases of Treasuries by more than a third, to $42.9 billion. Net foreign buying of all sorts of long-term securities from American residents fell to $45.7 billion, from $84.1 billion in February.

True, official purchases had ticked up in February. True again, it was Norway—not South Korea or China—that was the big seller of Treasuries, unloading $17 billion-worth in what was presumably a one-off sale. Despite these special factors, the March net inflow of foreign capital was insufficient to finance even that month's trade deficit, though the deficit was smaller than usual.

Yet investors are unfazed by figures that would once have put them in a tizzy. They apparently have bigger things to worry about. Ructions in the corporate-bond market following the credit downgrade of General Motors and Ford on May 5th and fear of continuing hedge-fund woes have sent them haring after safer assets—ie, Treasuries. Meanwhile the dollar is on a roll, as economic growth in Europe remains weak. Finally, two months is a long time in statistics collecting: signs suggest some Asian central banks have been buying again since March.

The fall in central-bank buying of Treasuries may well be a blip, and private demand for these and other dollar-denominated assets remains strong. But some worries have not gone away. One is that if Treasuries are relying on hedge funds for support, they may find themselves leaning on air before they know it. And if those Caribbean-domiciled funds are using money borrowed from their American bankers to buy the bonds, then they are hardly bringing foreign money to the party, are they?

Brad Setser, of Roubini Global Economics, a consulting firm, suggests a further point. The universe of official buyers is changing, and with it the degree to which these once faithfully followed statistics provide a reliable guide to what is going on. Gone are the days when Japan, with its preference for Treasuries and transparent reporting of trades, dominated purchases. China, for one, is as diverse in its investment appetite as it is opaque in its trading. The same is true, in spades, of oil exporters, with their fast-building surpluses.

By chance, it seems, Standard & Poor's chose May 16th to reaffirm the American government's AAA credit rating. The agency cited, among other things, the advantages of the dollar's role as the world's reserve currency, which helped to outweigh the country's twin deficits and low household savings. It was a strange counterpoint to statistics showing that this unique role might just be in jeopardy.

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Morgan Stanley

Caveat vendor

May 19th 2005 | NEW YORK
From The Economist print edition

A Florida court wallops one of Wall Street's top investment banks

COULD the headlines get any worse for Morgan Stanley? Already facing an attempt by dissident former managers to unseat its chief executive, on May 16th the investment bank was ordered by a Florida court to pay $604m for defrauding Ronald Perelman, one of America's smartest and richest investors. Mr Perelman contended that Morgan Stanley had misled him in 1998 when he agreed to accept shares in its client, a second-rate appliance manufacturer named Sunbeam, in exchange for his controlling interest in Coleman, a supplier of camping equipment.

And yes, things could get worse. On May 18th, after no more than a brief deliberation, the jury decided to award Mr Perelman another $850m, this time in punitive damages.

Morgan Stanley says that it is planning to appeal and that it was “not permitted to defend itself on the merits.” Quite so. In a pre-trial ruling on March 3rd, the judge, Elizabeth Maass (sitting in the Florida district where Sunbeam had been based), had instructed the jury that the bank had conspired with Sunbeam to defraud Mr Perelman; the only questions were the extent to which he had relied on the misleading information and the size of the resulting loss. That left Morgan Stanley unable to argue that it was not a party to fraud but itself a victim of it: witness its own $300m loss on the deal.

The jury was thus spared one of the sorriest business stories of the past decade. Sunbeam had long been a disaster when it decided in 1996 to bring in the executive hero of the moment, “Chainsaw Al” Dunlap, who had managed profitably to gut and sell Scott Paper, a troubled papermaker, before celebrating his methods in a self-congratulatory book, “Mean Business”. His tenure at Sunbeam resembled a caricature of capitalism. It began with lots of firings and an overstatement of losses. Reserves were built up and then released, augmented by fraudulent sales; that created the illusion of a fast turnaround and boosted the share price before, inevitably, the charade became apparent. In 2002, Mr Dunlap settled charges with the Securities and Exchange Commission by paying a fine and agreeing that he would never again be an officer or director of a public company.

Mr Dunlap's fast work at Scott endeared him to few employees, but made him sought after by bankers. Morgan Stanley was just one of many firms wanting his business. In Mr Perelman, Morgan Stanley found a buyer who seemed well equipped to cope with the Chainsaw Als of this world, having acquired an intimate familiarity with the challenges of managing suspect firms. He still controls Revlon, an ever-struggling cosmetics company, and had a controversial stint atop Marvel Entertainment, a publisher of comic books, that earned him a fortune even as it left the company bankrupt. Earlier in the 1990s, Mr Perelman had benefited hugely from the government-sponsored bail-out of the savings-and-loan industry.

Further, Mr Perelman, like any other billionaire, could afford the finest financial and legal advice that money can buy. And, if that were not enough, Coleman had overlapping distributors with Sunbeam. He was in an excellent position to ignore whatever blather Morgan Stanley had to say in favour of his own investigation into Sunbeam's recovery.

Yet none of this was ever brought before the jury, because of something that turned out to be critical to Morgan Stanley's defence. It had consistently failed to turn over internal e-mails. As the bank had done in other investigations, it blamed the omissions on computer errors and the like. This time, however, in Mr Perelman it faced an adversary who was implacable, well represented and determined to extract more than a token settlement; past opponents, mainly regulators, have been more easily satisfied.

Worse still for the bank, it faced a judge who found its delays and evasive answers to requests

intolerable. “Many of these failings were done knowingly, deliberately and in bad faith,” concluded Judge Maass, in her critical pre-trial ruling. “A reasonable juror could conclude that evidence of Morgan Stanley & Co's misconduct demonstrates its consciousness of guilt.”

That ruling, and the thought that lots of embarrassing dotcom-era e-mails might come to light, will warm the heart of many a plaintiff lawyer. And an odd twist to the Sunbeam case is worth a moment's meditation—not for Morgan Stanley specifically, but for the whole financial industry. According to Mr Perelman's allegations, the company's problems came to light only because of the demands of its auditor: Arthur Andersen, an accounting firm once renowned for its probity. How easily can reputations crumble to dust.

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The European Bank for Reconstruction and Development

Going east

May 19th 2005
From The Economist print edition

Europe's ex-communist economies are changing. So must the EBRD

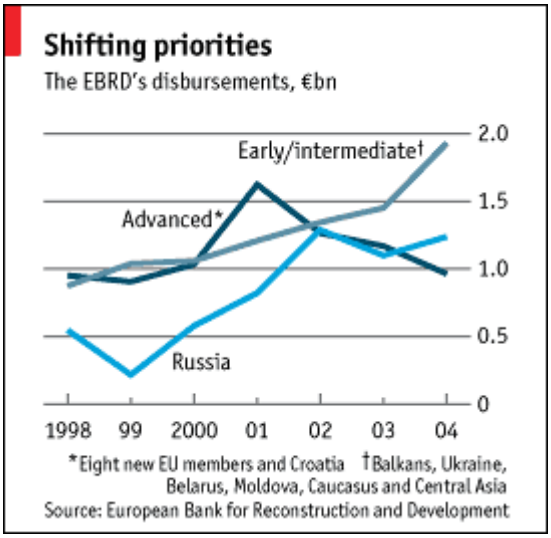
WHEN the European Bank for Reconstruction and Development (EBRD) holds its annual meeting in Belgrade this weekend, it will have good reasons to celebrate. The bank, founded in 1991 to help free markets take root in the ex-communist countries of central and eastern Europe, now counts eight members of the European Union among its clients; others are knocking on the EU's door.

However, such developments raise awkward questions about the future. “The EBRD was never meant to be a permanent institution,” explains Mark Sullivan, America's director at the bank. When, therefore, should the EBRD declare its job in a country done, and withdraw? And how far and fast should it shift its operations eastwards, within Europe and into central Asia?

The bank is bound by its constitution to promote private enterprise in countries “committed to and applying the principles of multi-party democracy, pluralism and market economics”. The political upheavals in Georgia and Ukraine, by this standard, are encouraging. Russia, the recipient last year of about one-third of the bank's investment, looks less promising. Uzbekistan, where government troops killed hundreds of people last week (see article), is downright grim. The EBRD has put a little money into businesses there—enough to make the bank the country's largest foreign investor—and to the consternation of many held its annual meeting in Uzbekistan two years ago.

Because of its private-sector focus, the EBRD is not a traditional development bank. It hands out no grants for broad goals such as the alleviation of poverty. Almost all its investments, made alongside private banks and companies, are in for-profit ventures. And it is expected to make money itself. It is in decent shape, with a profit of €298m ($370m) last year. This marks a good recovery from 1998, when the Russian crisis cost the bank more than €500m, drove it to a loss of €261m and wiped out its reserves. Stricter cost-control, better risk-management—cutting non-performing loans from 12% of the total in 1999 to 4%—and sounder investments have helped repair the damage. Reserves are now €1.8 billion; at €2 billion, the bank could in theory pay a dividend, although it would probably plough money back into the business instead.

The EBRD's biggest challenge is not one of money but of vision. As its operations migrate from central Europe to the Balkans, Russia, the Caucasus, central Asia and, soon, Mongolia, what sort of institution will it, and should it, become? Arguably, Hungary, Poland and others are ready for “graduation”—EBRD argot for the winding-down of operations in a country deemed to have made the transition to a free-market system. The share of the EBRD's investments going to central Europe (under which heading it includes the Baltic states and Croatia) is falling, to 23% in 2004, against 40% in 1998. The share of Russia and others has been on the rise (see chart below).



Some shareholders, led by America, believe that the bank should set a firm deadline for withdrawal from the most advanced countries. This, they say, will allow it to focus its cash and its staff's brains where help is needed most. They also worry that lingering in advanced countries might crowd out the private sector—even though the EBRD says it takes pains to tread only where private lenders will not go alone, acts in partnership with private institutions and prices its investments at market rates.

Others argue that even in the countries that have joined the EU there is still plenty to do. Some regions, such as rural Poland, lag behind. Some financial services, such as small-business lending, are not yet well developed. Bond markets lack liquidity. Many private-sector banks like to have the EBRD alongside them: "It protects us from reputational risk should something go awry," says one investment banker. "The EBRD is a stamp of good housekeeping."

A shift in region will require a shift in strategy too. In the Caucasus and central Asia, especially, the private sector is tiny, crony capitalism is rampant and public-sector loans may well end up in officials' and politicians' pockets. So the EBRD says it must switch to more traditional development work and grants, for example to strengthen legal or regulatory institutions. For-profit ventures will focus on micro-finance and small-business lending, which will require more time, staff and risk and, at least initially, will produce less profit. Last year, the bank launched an initiative for its seven poorest client countries, financed by grants from shareholders' donations and concentrating on microloans and lending to small businesses.

The push eastwards is spurring a rethink of the EBRD's political mandate too. So far, the bank has chosen to treat Russia with mild remonstrations. It has a formal ban on public-sector loans to Belarus and Turkmenistan, and is not making such loans to Uzbekistan either. Whether this will have any effect is moot. After all, says Laurent Guye, another director of the bank, "the success in central Europe was mostly due to the carrot and stick of EU membership—not EBRD prodding."

Most bankers seem to think that the EBRD has a role to play farther east. That might turn out to be correct. Simon Ray, the British director of the bank recalls that, in the wake of the Soviet Union's demise fourteen years ago, "Romania and others, too, seemed impossibly difficult. Look at them now."

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About sponsorship

Consumer lending in India

Niggles and nerves

May 19th 2005 | MUMBAI
From The Economist print edition

Growing pains in retail banking

THE past few years have been kind, by and large, to the customers of Indian banks. Banking has become more convenient; banks have been keen to lend. Retail loans, which make up one-fifth of all bank credit, now stand at 1.9 trillion rupees ($43 billion). Top bankers estimate that their retail lending has grown by 30% a year in the past few years; mortgages, which make up half the total, have been rising faster still. According to a study sponsored by Visa International, a payment-services company, the number of credit and debit cards grew at an annual rate of 55% in the seven years to 2004. There are 44m of them, 14m of which are credit cards.

However, not everyone is content. Customers are beginning to grumble about, well, the sorts of things that rile customers the world over, such as charges, which were deregulated six years ago, and service standards. Most banks insist that customers keep a minimum amount in their savings accounts (which carry lower rates than normal time deposits) and penalise those who do not. They also charge customers who withdraw cash from branches too often; the idea is to encourage them to use automatic dispensers. People also moan about the 35% annual interest rate on most credit cards, the aggressive methods of debt-collection agents and pushy telemarketing.

All this has prompted the Reserve Bank of India (RBI), the central bank, to announce, at the end of April, the creation of an independent banking code and standards board. The standards board will be expected to ensure that banks adhere to practices laid down by the Indian Banks Association, an industry club. These may include a “do not call” register for bank customers and penalties on banks that charge for unsolicited credit cards, as recommended by a panel set up by the RBI.

While customers are disgruntled, regulators are a little nervous about banks' pursuit of retail borrowers. Last year banks were asked to assign more capital to cover home and consumer loans. The risk weight on credit cards was increased from 100% to 125%. (Such weights are used to adjust a bank's assets for risk, in order to calculate capital requirements.)

Consumer credit in India is growing from a modest base, of under 5% of GDP, says K.V. Kamath, chief executive of ICICI, India's second-largest bank; it is nowhere near the level in South Korea, which suffered a consumer-credit boom and bust a couple of years ago. As long as banks do not offer loans absurdly cheaply, they will avoid “adverse selection” of customers, says Aditya Puri, who heads HDFC Bank.

Default rates on bank retail loans, at 2.5%, are not yet alarming. However, credit-card defaults have risen to 6.3%. One problem is that borrowers' credit histories are not generally available. A credit bureau set up last year by State Bank of India (SBI), the largest commercial bank, HDFC, the largest mortgage lender, and Dun & Bradstreet, a business-information firm, has data on around 20m retail borrowers, but so far only 30 of the 100-plus banks that have signed up disclose data to it. (This week, several banks, including Citibank and HSBC, bought stakes in the bureau from SBI and HDFC.)

Bankers say progress is hampered by the lack of a unique proof of identity for each customer, such as a social-security number, and because full access to customer data is not available from public-sector banks not networked by computers. Parliament has now passed a bill that should help banks to share credit information. Better data would lessen the chance that India's lending boom end in tears.

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The World Trade Organisation

A wager on Pascal

May 19th 2005
From The Economist print edition

The WTO puts its faith in Pascal Lamy

Get article background

AP

The cap fits Lamy

MISSILE, monk and marathon man. There are not many figures in the grey world of trade negotiations who inspire such vivid imagery. But Pascal Lamy, the European Union's former trade commissioner, selected on May 13th as the next director-general of the World Trade Organisation (WTO), is just such a character. He has been compared to an Exocet, because of his brisk and unerring manner; likened to a monk, by virtue of his austere appearance; and admired as a runner of marathons, whose stamina has been tested as much in the negotiating room as on the roads.

Mr Lamy has been an occasional critic of the organisation he will lead. He once described the WTO's negotiating procedures as “medieval”. But its procedure for picking him as its next chief was surprisingly enlightened. Four candidates stood. All 148 members were sounded out. After each round of consultations, the candidate enjoying the least support stood aside. As a result, the WTO will have a leader in command of his brief and with broad support from the membership. If only every international organisation were so fortunate.

Mr Lamy's term, which does not begin until September, starts very late in the day for the Doha round of global trade talks. In December, Hong Kong will host the summit at which the big political decisions on a global trade deal must be taken, if the technocrats are to have time to do the rest. The director-general cannot force a consensus that does not exist; but he can steer members towards a consensus they might not otherwise find. However tightly run the summit is, it may still fail. But if it is poorly run, it almost certainly will.

Mr Lamy must still prove his credibility as an honest broker of this deal. As the EU's trade commissioner, he was a partisan, fighting Europe's cause. He is already distancing himself from that role. By the final round of consultations this month, his support was confined neither to Europe nor to former colonies, with which the EU has cut exclusive trade deals. He also won over some of the more influential members of the G20, a group of developing nations pushing for bigger trade concessions from the rich world.

They probably concluded that any EU trade commissioner, if he is doing his job, is bound to defend some dubious causes. An advocate's skill is judged by how well he makes his case, not by the merits of the case itself.

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Economics focus

Relax! It's the law

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Would Americans like to work as little as Europeans? What's stopping them?

MOST people greet the weekend with gratitude. But some economists view it with puzzlement. Why, they wonder, does the bulk of the population rest on the same two days each week? Why does everyone's week end at “the” weekend? From an economic point of view, it would surely be more efficient to stagger days of rest throughout the week. That way, expensive pieces of equipment would not lie idle for two days in seven, and infrastructure would be less congested the other five.

One person impressed by this logic was Josef Stalin, who rationalised the Soviet calendar in 1929. Workers were given every fifth day off, but their shifts were staggered, so that factories could run without interruption. The staggered week appealed rather less to the people who worked it, however. According to Witold Rybcynski's 1991 book about leisure, “Waiting for the Weekend”, Stalin's four days on, one day off, was unpopular, even though it was less onerous than the six-day week that preceded it. Families and friends rarely had the same day off; administrative staff rarely worked at the same time. After less than three years, the staggered working week was abandoned.

Echoes of Stalin's discovery can be found in a recent paper* by Alberto Alesina and Edward Glaeser, both of Harvard, and Bruce Sacerdote, of Dartmouth College. The authors begin from the premise that Stalin unwittingly proved: people complement each other at work, and perhaps at play too. Couples want to go on holiday together; parents want time off when schools are out. As a result, the economists say, people do not make solipsistic decisions about how much labour to offer in the marketplace. Their choice depends on everyone else's. Knocking off early carries less of a stigma if others do the same. Jobless youth find unemployment more tolerable if their friends are also out of work. Conversely, an ambitious underling will want to put in at least as many hours as his boss, whatever time she clocks off.

Messrs Alesina, Glaeser and Sacerdote think this principle might help to explain why Europeans work so much less than Americans. The gap is quite striking. According to the Luxembourg Income Study, the typical American worker puts in 1,820 hours over the course of a year. Meanwhile, according to the OECD, his German and French counterparts clock up a mere 1,480 and 1,467 hours respectively. They put in five or six fewer weeks per year, and three fewer hours per working week.

Edward Prescott, a winner of the Nobel prize for economics, blames these transatlantic differences on tax. Europeans would like to work more, but are deterred by the high percentage of their extra earnings the state would confiscate. Olivier Blanchard, an economist at the Massachusetts Institute of Technology, puts it down to transatlantic differences in taste. Europeans, he says, put a higher implicit price on their leisure. “There is plenty of anecdotal evidence that Europeans enjoy their leisure more than their American counterparts,” he writes.

But why? Some speculate that Americans, being the cultural heirs of the industrious Puritan settlers, are still gripped by a Protestant work ethic. However, as recently as 1970, Europeans worked more each year than Americans. Why should their work ethic have lapsed since then?

Rather than blaming culture or taxes, Messrs Alesina, Glaeser and Sacerdote instead credit trade unions. The strength of organised labour peaked in Europe in the 1970s, about the time that work hours started falling. After the first oil shock of 1973, the authors write, Germany's unions marched to the slogan “work less, work all”, and the same mantra, in different languages, was recited across the continent. In France, the unions eventually won an agreement in 1981 to cut the working week to 39 hours. The government then took up their battle, culminating in the national 35-hour week implemented in 2000. Indeed, their cause has gone continent-wide. The European Union's working-time directive, first issued in 1993 and

subject to fierce debate again this month in the European Parliament, insists that workers toil no more than 48 hours each week on average (see article).

Let's all go home

There is an obvious liberal objection to any regulation of work hours: workers should be free to sell as much or as little of their labour as they wish, and employers free to buy as much as is profitable. Union demands and working-time directives are unnecessary encumbrances, stopping workers and employers striking deals to their mutual advantage.

But Messrs Alesina, Glaeser and Sacerdote float an alternative possibility. Such regulations might solve a co-ordination problem, they suggest. If Europeans complement each other at work and rest, they may prefer to work shorter hours and fewer weeks provided others do the same. If so, the authors write, "national policies that enforce higher levels of relaxation can, at least in theory, increase welfare." Perhaps Americans would also like to work less, if their family, friends, or bosses worked less also. But in a competitive economy there is no way to co-ordinate their decisions. The individual American can act with others, but not too far ahead of them.

By recent evidence, however, Europe's unions got ahead of themselves. By demanding shorter working weeks with no loss of pay, they raised the cost of labour and undermined employment. In the past year or so, the French government has backed away from the 35-hour week, and German unions, most prominently at Siemens and DaimlerChrysler, have agreed to work longer for no more pay. The unions that once marched to the slogan "work less, work all", have now conceded the need to work more, if they are to work at all.

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* "Work and leisure in the US and Europe". Prepared for the NBER Macroeconomic Annual, 2005

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Stem cells

The dogs bark, but the caravan still moves on

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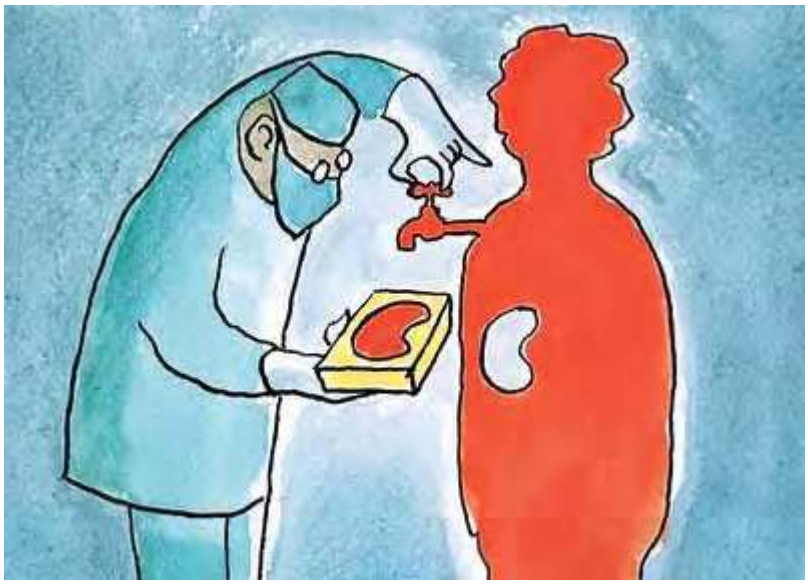

More progress in the study of human stem cells

Get article background

AMERICA'S loss is Korea's gain. Unlike many Americans, up to and including the president, Korean scientists—and the authorities that support them—do not wring their hands in agony about experimenting on tiny clusters of cells that might, in other circumstances, grow into people. They just get on with it. The latest paper in the field, published this week in *Science*, has 25 authors. They were led by Woo Suk Hwang of Seoul National University, and all but two of them, who are at the University of Pittsburgh, work in South Korea.

The tiny clusters of cells in question are known as blastocysts. A blastocyst is the precursor to an embryo. It contains a number of so-called stem cells that are capable of differentiating into many different types of tissue. Optimists hope stem cells might be used to generate replacement tissues—and even entire organs—for those who have lost their originals to disease. But not just any old stem cells. Using stem cells derived by cloning from the very patients who need the transplants might get around the problem of rejection by the immune system that bedevils transplant techniques at the moment.

This hope, combined with the ethical fears about such research that some people have and—inevitably—the suggestion that cloning blastocysts might lead to cloned people, meant that when Dr Hwang published a paper last year describing the creation of the first cloned human blastocyst, the announcement was accompanied by a lot of excitable comment in the media.

That study, however, was merely a proof of principle (and a proof that has been contested by some other researchers). This week's paper addresses the concerns of the sceptics who questioned whether Dr Hwang had actually cloned anything, rather than simply stimulated unfertilised eggs to start dividing and growing by themselves (a process known as parthenogenesis). It also moves things on a little towards the point where the technique might be useful.

Embryonic ideas

Clones come in many varieties. Some, such as identical twins, are formed when an embryo divides. Others, such as plant cuttings, start with part of an adult. The form of cloning Dr Hwang uses is known as nuclear transfer. This involves taking the nucleus out of an unfertilised egg and replacing it with one from an adult cell.

The reason for this convoluted procedure is that adult mammal cells are set in their ways. Once they have specialised into a particular type of tissue (skin, muscle or whatever), they cannot easily be induced to go backwards. But the isolated nuclei of such cells can sometimes be persuaded to revert by exposing them to the inside of an egg. In effect, this creates a fertilised egg without going through the process of fertilisation. This egg, though, has the same genetic complement as the adult from which the nucleus came. Anything that grows from it is thus a clone.

In last year's paper, Dr Hwang described transplanting human nuclei this way, but only from the adult cells of the women who provided the eggs. Such “auto-cloning” would be of limited therapeutic use. The main advance reported in the new paper is therefore that human nuclear-transfer cloning works whether or not the nucleus donor and the egg donor are the same person. At least as important for half of humanity is that it works even when the two individuals are of opposite sexes. Nor does age appear to be a factor. Nuclei from people as young as two, and as old as 56, were successfully transplanted. And in a move that might spike the guns of some critics of the ethics of the whole procedure, all of the nuclear donors suffer from conditions such as diabetes and spinal-cord injuries that successful cloning might help to treat.

Altogether, Dr Hwang and his colleagues managed to create 31 cloned blastocysts, and to establish 11 self-perpetuating cultures (known as cell lines) from stem cells they extracted from these blastocysts. By combining nuclei and eggs from different people they showed that there was no parthenogenesis. And they also managed to grow their blastocysts and cell lines on so-called feeder cells derived from humans, rather than relying on mouse feeder cells as they had done previously. That will make the cloned stem cells safer to use by eliminating the risk of transferring mouse viruses to patients.

That there is still a long road from this work to transplantable tissues is denied by no one. But Dr Hwang and his team are striding boldly down it. Who will follow in their footsteps remains to be seen.

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Cancer prevention

Lifestyle vaccines

May 19th 2005 | ORLANDO
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Taking the work out of quitting—maybe

Reuters

The shadow of lung cancer

SMOKING causes a third of cancer deaths, but quitting brings immediate benefit. In fact, someone who quits before the age of 50 is half as likely to die of cancer in the subsequent 15 years as he would be if he kept smoking. The trick, then, is helping people quit. With that goal in mind, Cytos Biotechnology, in Zurich, has, as it announced to the American Society of Clinical Oncology meeting held last week in Florida, made progress in developing a vaccine against nicotine.

Normally, when someone smokes a cigarette, the nicotine in it is carried to his brain in the bloodstream. Once there, it stimulates a neural circuit that provides a sensation of pleasure. That sensation reinforces the desire for another cigarette, making it hard to relinquish the habit.

The idea of a nicotine vaccine is to stop the drug getting to the brain in the first place. People who are vaccinated should develop antibodies that bind to the nicotine in their bloodstreams, disabling it. If no nicotine reaches the brain, there will be no pleasurable reward for having a cigarette. So vaccinated individuals should—in theory—be less likely to relapse. This approach is not unique to nicotine. Vaccines against cocaine, another addictive recreational drug, are also being developed. But the results announced in Orlando suggest that Cytos's nicotine vaccine is now the closest to being deployed.

Jacques Cornuz of the University Hospital in Lausanne, who actually conducted the trial for Cytos, enrolled a group of long-term smokers into a trial. One-third of the volunteers received a placebo, while two-thirds were vaccinated with nicotine bound to a bulky protein mass. Because the nicotine was attached to this protein, the immune system saw it as a potential invader. All of the vaccinated volunteers produced antibodies designed to attack it.

After six months, Dr Cornuz and his colleagues looked at the results in the 239 volunteers who had been treated throughout the period. They found that 40% of those in the vaccinated group had successfully abstained from smoking from the eighth week of the trial onwards, compared with 31% in the placebo group. That might look good, but in fact it is not a statistically significant difference. However, when they divided the vaccinated volunteers into three groups, based on the concentration of antibodies the volunteers' immune systems had produced, they saw a different picture.

Those who had had only weak antibody responses to the vaccine behaved much like the placebo group, with 32% managing to quit. By contrast, 57% of those in the sub-group with the strongest antibody response managed to stay the course. That was a statistically significant improvement on the placebo, and implied that the vaccine does indeed help some people stop smoking.

This result leaves two possibilities open. One is to try to identify in advance of vaccination who will benefit. Variable responses to medicines are often due to genetic differences between patients, and modern techniques are starting to be employed to track them down. The other approach is to tinker with the way the vaccine is delivered, and also the size of the dose, to see if it is possible to induce a strong antibody response in more people. Cytos's researchers are taking the second approach and, if they are successful, they will start a large clinical trial to see if vaccination works in the general population.

In the meantime, they note that the 31% cessation rate achieved in the placebo arm of the trial is far higher than is seen in a typical population. The American Cancer Society, for example, estimates that only 5% of those who try to quit smoking manage to remain cigarette-free for 12 months. The Cytos team thinks that the difference is caused by the counselling everyone in the study received throughout its duration. So those smokers too impatient to wait the five years that it will take to get a vaccine approved (assuming such approval is granted) might instead prefer to head for their local counselling centre for some good old-fashioned support.

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Seismology

Shaky ground

May 19th 2005
From The Economist print edition

Better earthquake forecasting is possible. But not prediction

“OVER the next few days there is a high probability of thunderstorms, the pollen count will be low and the chance of being shaken by an earthquake will be moderate.” Such a forecast might seem like a stretch of the imagination, but in California it isn't. From now onward, the people of that state will indeed be able to check their daily earthquake forecast on the internet, at a new website.

The science of predicting earthquakes—that is, saying in advance precisely when they will occur and how powerful they will be—has been about as successful as the alchemists' search for the philosopher's stone that was supposed to convert base metals into gold. Instead, seismologists have focused on the less precise goal of forecasting the probability of a quake happening in a given period of time, based on past occurrences. Until now, however, the time-frames of such seismological forecasts have tended to be measured in decades, rather than hours.

The technique employed to generate California's daily earthquake forecast is the work of a group of researchers led by Matthew Gerstenberger, a seismologist at the United States Geological Survey (USGS) campus in Pasadena, and published in this week's *Nature*. The USGS already issues traditional forecasts—long-term hazard maps that show the likelihood of a particular place experiencing serious ground-shaking within a 50-year period. These are used for such things as calculating insurance premiums and drawing up building codes. But Dr Gerstenberger and his colleagues have come up with a technique that aims to calculate the probability that any given spot will suffer a shaking over the next 24 hours.

They have done so by adding predictions from seismological rules called the Gutenberg-Richter relationship and the Omori law to the USGS model. The Gutenberg-Richter relationship describes the size distribution of earthquakes. The Omori law states that the aftershocks which follow an earthquake occur at a rate which decreases predictably with time. Given the frequency of earthquakes in California, this pattern of aftershocks is in constant flux, which is what causes the forecast to change from day to day.

The first maps released to the public were mostly various shades of cool blue—depicting risks of between one in a million and one in 100,000. The brightest spot on them, in yellow, is over Parkfield, California. Yellow means there is a one in 100 to a one in ten chance of severe shaking in the next 24 hours.

That will come as no surprise to the 34 residents of Parkfield, a town located on the San Andreas fault—one of the longest and most active in the world. Parkfield is well known as an earthquake-prone place. Indeed, it is one of the most heavily monitored parts of the planet, because there is a suggestion that earthquakes there may be cyclical, and thus easier to predict. If scientists want to study biodiversity they go to the tropics. If they want to study seismology they go to Parkfield.

Despite this, and the fact that some 200 research papers have been written about Parkfield's seismology, not a single actual earthquake has been successfully predicted in Parkfield. Not one. A magnitude 6.0 earthquake was supposed to strike the place sometime before 1993. It actually happened late last year. Indeed, it was the failure to make an accurate prediction at Parkfield that killed most seismologists' hope of ever doing it anywhere.

How useful the new forecasts will really be remains to be seen. The problem with the kind of modelling used is that the only time a large, red (ie, risky) area is likely to appear on one of Dr Gerstenberger's maps is just after a big earthquake, which would raise the risk of strong aftershocks. The big earthquake itself, though, the maps would not predict.

But they will, at least, provide a topic of conversation. In the same way that the British are fascinated with the weather, Californians are fascinated by earthquakes. After a big event, Dr Gerstenberger hopes that many people will be interested in how their local risk has changed—a risk, he says, that could alter quite rapidly from day to day. Whether those people will modify their behaviour as a consequence is a different question.

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The Eurovision Song Contest

Musical chairs

May 19th 2005
From The Economist print edition

Musically, Britain is Europhile and France Europhobe

WHAT makes a good song? Lyrics, melody and rhythm have their place, of course, but for entrants of the Eurovision Song Contest on May 21st, geopolitics may be the decisive factor. Neil Johnson and his colleagues at Oxford University have gathered voting data from 12 years worth of Eurovision Song Contests in order to analyse the links between different countries, and their "compatibility" with each other. These data confirm what many already suspected: that the contest is not always about the quality of the songs. The research, published in arXiv, an online archive more usually devoted to papers about physics, has shown the contest also has a deeper meaning, and reveals how "European" each country is. Despite its Eurosceptic image, for instance, the data suggest that Britain is very much in tune with the rest of Europe. Supposedly Europhile France, by contrast, is actually out of kilter with many of its European cousins.

Dr Johnson and his colleagues picked the Eurovision contest for their analysis because it is largely free of economic and governmental bias, and does not depend on income, on education or (much) on language. This, they argue, makes it a good measure of compatibility between countries, capturing something of the underlying character and mood of a given country at a given time. If all were fair and equal, and judges had similar musical tastes, any given song should receive a similar score from all countries, with terrible songs garnering few points and good songs many. In reality, though, some dreadful dirges get a few ridiculously high scores, while better ditties receive a smattering of surprisingly low ones.

There are two possible explanations for this. One is that things are not, in fact, fair and equal. The other is that the judges do not have similar musical tastes. In practice, the researchers found, both are true.

To analyse the anomalies, Dr Johnson and his colleagues generated 12 years worth of results for imaginary contests in which all songs were equally nice and there were no biases between countries. Then they compared these artificial results with the real scores between 1992 and 2003, and looked for persistent and unusual voting patterns.

Voting cliques were immediately apparent, with geographical gangs of countries that show a strong tendency to vote for each other, such as the Nordic bunch, and political allegiances between countries such as Greece and Cyprus. But some cliques, such as that between Croatia and Malta, defied explanation, with no obvious geographical or political connection.

More intriguing, though, were apparent cultural affinities. Britain turned out to be part of the European in-crowd. Its voting patterns were even-handed and close to the norm. France and Spain, by contrast, were outliers in the scoring system—though not because they were parts of voting cliques. Instead, Dr Johnson suggests, the French and Spanish judges behaved as though they had inflexible views about the right type of song, only to find that the views of all the other countries had moved on with the times.

In future years the authors are keen to observe how inter-country relationships continue to develop and, in particular, what the impact of Middle Eastern countries joining the contest will be. For now, though, they are waiting to see what horror the judges will inflict on a hapless continent this time.

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France and the second world war

Monstrous or maligned

May 19th 2005
From The Economist print edition

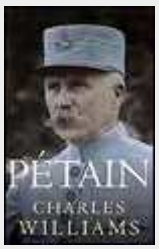
Topfoto

Was France's wartime leader, Marshal Pétain, really just a cipher? A new biography is too soft on the "Saviour of Verdun"

HENRI-PHILIPPE PETAIN was the most obscure of those men who gave their names to the "isms" of Europe's dark years. Born in 1856 into a relatively prosperous peasant family in northern France, he followed—with the help of an uncle who was a priest—one of the classic routes of social mobility, the army. Pétain commanded regiments, lectured at the École de Guerre and was about to retire a colonel when the first world war plucked him from mediocrity. By 1918 he was one of only three marshals of France, the country's highest honour.

Much of this was due to chance. Certainly, Pétain was no Napoleon, observes Charles Williams, who has also written about Charles de Gaulle and Konrad Adenauer. But he was ideally placed to gain rapid promotion, being young enough to stand the pace, senior enough to be out of the carnage and intelligent enough to understand the reality of industrialised warfare. One thing lifted Pétain above the crowd of be-medalled survivors: his pessimism. Pétain did not believe that courage and persistence could force flesh and blood through barbed wire and gunfire.

Pétain.
By Charles Williams



Little, Brown; 568 pages; £30. To be published in America by Palgrave Macmillan in October

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After 1917, Pétain became identified with a defensive stance in both strategy and tactics. If this came close to getting him the sack, it also won him the undying devotion of thousands of soldiers. Thus the myth of the paternal "Saviour of Verdun" overtook the reality of the desiccated professional soldier. The apotheosis came in 1940, when Pétain, by then white-haired and quavering, offered himself to save France. He was elevated to the status of quasi-monarch and reigned for four inglorious years from the genteel spa town of Vichy. After France was liberated, Pétain was sentenced to death for treason. This was commuted to life imprisonment, and successive French presidents, including De Gaulle and François Mitterrand, continued to have flowers placed on his grave to mark the anniversary of his death in 1951.

If the strangeness of Pétain's destiny makes him an intriguing subject, it also accentuates the problem of perspective inherent in historical biography. Even studies of such dominating figures as Churchill or Hitler

inevitably risk distorting great events by projecting them through the acts and experiences of a single individual. The problem is magnified when myth overshadows reality.

It is far from clear that the story of Pétain the historical figure is explicable in terms of Pétain the man. Several French historians have tackled the problem by analysing the myth, explaining, for example, why the themes of the Saviour, the Leader, the Father (or Grandfather) of the Nation were so compelling. This is not Mr Williams's approach: he writes about the flesh and blood Pétain—and he writes very well. The pacing of the narrative and the observations of place, time and character are managed with admirable skill; peasant society, the army, the atmosphere at Vichy, the trial and the final years of imprisonment are vividly rendered. Mr Williams makes Pétain interesting—no simple task. He was cold, selfish and rather one-dimensional. If his life-long philandering recalls the seedy glamour of Maupassant, the women involved are now no more than names. Except as a monument to the hypocrisy of respectable French society, even his odd relationship with Nini, his long-time mistress and finally wife, remains enigmatic.

Trying to distinguish what Pétain did from what happened to him has been the subject of long historical debate. After the war, sympathisers presented him as a tragic and pathetic figure, a heroic old man doing his best as his faculties failed and ruthless politicians manipulated him. Mr Williams does not wholly take this view, nor does he reject it. He criticises Pétain, yet this chronicle of Vichy life, detailing his daily walks, medical problems and lapses of memory, based largely on the memoirs of his entourage, bypasses the central issue. It ignores the conclusion of recent French historians that Pétain was not a senile cipher and that his influence was far greater than the tragic legend allows. The real tragedy is that Pétain's deep pessimism and hidebound narrowness of outlook played into Hitler's hands. Mr Williams's tentative suggestion that Pétain was a barrier to German policy is untenable. The “Saviour of Verdun” offered Germany exactly what it wanted: a supine France whose rulers co-operated in their people's enslavement.

By Charles Williams
. Little, Brown; 568 pages; £30. To be published in America by Palgrave Macmillan in October

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About sponsorship

The Turkic world

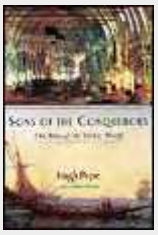
Muskets and mustachios

May 19th 2005 | ISTANBUL
From The Economist print edition

THE emergence of a clutch of newly independent Muslim Turkic states following the collapse of the Soviet empire in 1991 stirred up an intense, if short-lived, interest in the Turkic presence that stretches from the outer edges of China all the way to the Balkans. At its core lay Turkey whose ready, if wobbly, democracy, its free-market economy and its own brand of moderate Islam, western strategists hoped, could serve as a model.

Fired by visions of leading this Turkic world, imams, entrepreneurs and language teachers all poured into the former Soviet republics. But their fervour was soon tempered by Russia's continued political and cultural grip over its one-time colonies. With the exception of tiny landlocked Kirgizstan, each of these countries is still ruled by its corrupt former communist dictator, its every potential unfulfilled. Indeed, modern Turks often seem to have more in common with their Christian Greek neighbours than they do with their ethnic cousins in Azerbaijan.

Sons of the Conquerors: The Rise of the Turkic World
By Hugh Pope



Overlook; 432 pages; $35.
Duckworth; £20

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Hugh Pope, a veteran Istanbul-based correspondent of the *Wall Street Journal* and co-author with Nicole Pope of an unrivalled history of modern Turkey, “Turkey Unveiled”, might agree. Yet, in his ambitious new book, “Sons of the Conquerors”, Mr Pope seeks to unearth the common strands that link the 140m Turkic speakers across the globe. In a quest that takes him from the grim battlefronts of Armenian-controlled Nagorno-Karabakh in Azerbaijan to secret encounters with Turkic-speaking Uighur nationalists in China, he has produced the most comprehensive work on the Turks today. His book is also very timely. As Turkey prepares to open membership talks with the European Union later this year, Mr Pope's affectionate yet often critical gaze should help redefine the Shorter Oxford English dictionary's description of the Turk as “a cruel, savage, rigorous or tyrannical man”.

Part-travelogue, part-history and part-political analysis, “Sons of the Conquerors” overflows with hilarious anecdotes and distinctive characters that only someone who speaks Turkish, Farsi and Arabic as effortlessly as Mr Pope could dig up. There is the pan-Turkist Azerbaijani doctor, Timur Agridag, who milks Caucasus vipers; Aslan Abashidze, the president of the tiny autonomous republic of Ajaria, who believes his model of New York's Statue of Liberty is an image of the Virgin Mary; and Nadya Yuguseva, who is a witch-doctor cum priestess from Altay. “She wore a splendid, tall, round hat of reddish fur. I complimented her on it, and she told me it was a traditional shaman artefact made from the front paws of 12 foxes,” recalls the author.

So what are the essential characteristics that bind such Turks? The answer is not so clear, Mr Pope readily admits, as he charts their beginnings from the nomad armies who once conquered the Byzantine Empire, large chunks of Europe and the Middle East. Some are not Sunni but Shia Muslims, as in Iran; many in Soviet Central Asia are atheists. They often speak mutually unintelligible dialects.

Even so, Mr Pope sees some important and unmistakable similarities: “An engaging bluntness, loyalty to family, fearlessness and a rash love of risk,” that makes him hopeful for the future. Yet, the Turks' “ignorant pride can often give way to bombastic, insecure assertions of superiority.” Moreover, the “constant struggle in many Turkic hearts pits a love of authoritarian rule against a belief that the pleasures and profits in life are to be gained from bypassing the law in the manner of the heroic, mustachioed brigand.”

By Hugh Pope.
Overlook; 432 pages; $35.

Duckworth; £20

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Philosophy

Tease the mind

May 19th 2005
From The Economist print edition

A STANDARD charge against contemporary philosophy is that it has grown too technical and abstruse for all but initiates to understand. Articles in philosophy journals are like chess analysis, where adepts know the arguments and counter-arguments 20 moves deep. It is philosophy for philosophers, without regard for the rest of humanity. Philosophy, the critics say, involves large life-and-death issues that concern us all and should not be a professional reserve.

The complaint does not impress the profession. Nobody expects molecular biology or aircraft engineering to be intelligible to non-experts; people just want these practitioners to get it right. Yet few make the same allowance for philosophers. They are expected, unreasonably, to produce serious work that non-adepts can understand after, say, 30 seconds of uninstructed thought. Nor are technicality and abstruseness in philosophy peculiarly modern; just try the medieval scholastics, or Kant.

Had the argument ended there, we would not have either of these books. Both are from the Oxford University Press, whose commissioning editor for philosophy, Peter Momtchiloff, continues to build bridges between the two sides by observing the golden rule of good popularisation: no step is too hard to explain simply, but there are many, many steps.

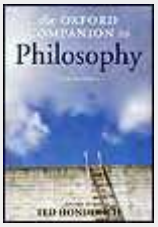
"The Oxford Companion to Philosophy" draws on 249 contributors, many of them leaders in their fields. Though most are from Australia, Britain and North America, where analytical philosophy is more firmly in the saddle, continental European and non-western thought also have their say. Entries are alphabetical, running from "Abandonment" to "Zoroastrianism". Most run to only a paragraph or two, though the entries on schools of thought or on great philosophers often stretch to a page or more. Many are models of exposition. Each has a short reading list. At the back are maps of topics and "isms", as well as a chronology.

Although it is a reference book, the "Oxford Companion" is rewarding to browse through. Authors have signed their entries, and you can pick up their interests and individual "voices" from article to article. This new edition is roughly 50 pages or 5% longer than the original of 1995. The main additions are new or revised country surveys and technical terms from recent controversies, as well as biographical items on thinkers who have made a mark in the past few years.

The "Oxford Companion" has competition. Routledge has brought out a concise version of its multi-volume "Encyclopedia of Philosophy", and Cambridge University Press its own updated "Dictionary of Philosophy". Both are fuller and more demanding, article for article. But the "Oxford Companion" is probably the best introductory guide to buy if you settle for one only.

Quite who "The Future for Philosophy" is intended for is hard to say, however. Its 13 entries were commissioned as situation reports. Some authors, notably Jaegwon Kim on how our minds fit into the physical world, David Chalmers on the nature of thought and Nancy Cartwright on the philosophy of science all map their territory well. Though hard going for non-specialists, their essays repay the work. Don Garrett explores contrasting approaches to the history of philosophy: as a sort of archaeology of dead ideas in their context or as an ongoing conversation with past thinkers. Missing is a separate article on one of the most striking recent developments in Anglo-American philosophy: the return to full-blown

The Oxford Companion to Philosophy
Edited by Ted Honderich



Oxford University Press; 1076 pages; $60 and £30

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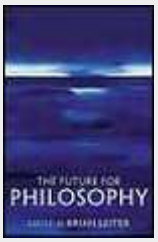
The Future of Philosophy
Edited by Brian Leiter



Oxford University Press; 372 pages; $35 and £26.50

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and often crazy-sounding metaphysics, argued out with the daunting resources of modern logic.

The editor of the collection, Brian Leiter, makes a plea for three thinkers whom the analytical tradition tends to neglect or dismiss: Marx, Nietzsche and Freud. Backing unfashionable figures is not the only reason he stands out. A while ago he hit on a solution to the question of how to rank philosophy departments. Defining and measuring philosophical output is a challenge, to put it mildly. Mr Leiter's answer was to ask philosophers themselves which departments were best. Out of their answers, after a statistical working-over, he built a league table, which he regularly updates. It is called the *Philosophical Gourmet* and you can see it on the web.

Although plenty of philosophers consult the *Gourmet*, it makes others of them cringe. Two years ago close on 300, including some from top-ranked New York University and Rutgers, wrote an open letter complaining that Mr Leiter's table measured reputation, not excellence, and that it was driving good students away from middle-rank colleges in a race for the top.

Interestingly, seven of Mr Leiter's 12 distinguished contributors to “The Future of Philosophy” are on his advisory board. None of them signed the letter of complaint. Who said philosophy was out of touch with the world?

The Oxford Companion to Philosophy.
Edited by Ted Honderich.
Oxford University Press; 1076 pages; $60 and £30

The Future of Philosophy.
Edited by Brian Leiter.
Oxford University Press; 372 pages; $35 and £26.50

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About sponsorship

Innovation in the theatre

Old spaces and new globes

May 19th 2005 | LONDON AND NEW YORK
From The Economist print edition

Building Elizabethan theatres once seemed ridiculous. Now everybody wants one

WHEN the reconstructed Globe Theatre opened on the south bank of the River Thames in 1996, some dismissed the project as yet another piece of heritage hocus-pocus, a Disneyland version of Merrie England, like re-enacting medieval jousts on the lawns of crumbling castles.

Yet nine years on, as Mark Rylance, its founding actor/manager, begins his farewell season, the Globe, a faithful re-creation of the 1599 original, has become one of London's liveliest cultural resources. Not only has it provided fresh insights into Shakespeare's work and that of his contemporaries, but it has sparked new interest around the world in all aspects of 16th- and 17th-century theatres: their architecture, their staging techniques, their audiences and the role they played in a largely illiterate urban society.

Encouraged by its success, the Shakespeare Globe Trust is preparing to launch the second part of the project as envisaged by the late Sam Wanamaker, the American actor whose perseverance brought it into being. The original plan was to build an indoor auditorium alongside the outdoor Globe, so that performances could take place all year round. This is historically relevant because for much of Shakespeare's time his company, the King's Men, alternated between the Globe and the indoor Blackfriars Theatre, a converted hall in a former monastery.

Nobody knows exactly what the Blackfriars looked like, but Inigo Jones—or possibly the architect's long-term assistant John Webb—drew a detailed design for an early indoor theatre. It may have been for the Phoenix in Drury Lane, which was converted from a cockpit in 1616; or it may never have been built at all. Wanamaker's idea was to use the plans to construct what would be called the Inigo Jones Theatre. The shell is in place but there has been no money available to fill it.

Now Mr Rylance and his colleagues are on the fund-raising trail again. In February about 100 scholars and supporters attended an architectural symposium at the Globe to discuss how the indoor theatre might work.

For the sake of authenticity, modern audiences at the Globe have to adjust their expectations to the conditions of four centuries ago. Several hundred “groundlings” stand in the pit, open to the elements, where they may exchange banter with the actors. People who pay more are able to sit on uncomfortable wooden benches in the narrow covered galleries. The Inigo Jones Theatre will make further demands on their adaptability for, according to the drawing, about a third of the audience will be seated at the side of the apron stage or behind it.

At the symposium, Andrew Gurr, a theatre historian who played an important part in the Globe project, made the point that Elizabethan and Jacobean theatre was primarily oral, not visual. Shakespeare's plays were produced with scant scenery. Audiences went to be seduced by his words rather than for the spectacle; so being close to the actors was more important than gaining a full frontal view. The seats in the gallery behind the stage were usually reserved for the wealthiest and most celebrated playgoers, wearing fine clothing that was the envy of the starstruck rabble in the pit.

It is not just modern audiences who need to adjust: so do the actors. Mr Rylance, whose numerous illuminating performances have been among the highlights of the Globe's first nine years, says he cannot now imagine playing Shakespeare in a conventional theatre, in which the audience can be seen only dimly across the footlights. “When I go to watch Shakespeare and the actor turns to speak a soliloquy, I think: Who are you speaking to? They aren't speaking to anyone because they can't see the audience. It's like playing football against a wall rather than another team.”

Mr Rylance's final season at the Globe began earlier this month. The 2005 repertoire will be made up of three of Shakespeare's late plays—“The Tempest” (in which he will play Prospero), “The Winter's Tale” and “Pericles”—as well as a modern version of Plautus's Greco-Roman comedy, “The Storm”.

After the season ends in London in October, the company plans to cross the Atlantic to play their wonderful all-male “Measure for Measure”, one of last year's hits, in Minneapolis and Los Angeles, as well as Philadelphia, Pittsburgh and possibly also New York.

The upsurge of interest in Elizabethan theatres has spread from the Globe to its once near-neighbour, the Rose, which opened in 1587 as the first playhouse in Southwark, predating the Globe by 12 years. Over the centuries the Rose's exact position was lost, until 1989, when archaeologists discovered the remains on a site newly cleared for an office block. Although a small viewing and exhibition space was preserved, only a portion of the theatre's foundations was excavated, and these had to be covered again to prevent any further deterioration.

Now the Rose Theatre Trust wants to excavate the remaining part and expose more of the earlier dig, turning it into a permanent exhibition with a performance space. A proposal is expected to be on its way to the Heritage Lottery Fund. Although there is no question of attempting to rebuild the theatre here, just revealing its foundations will be a valuable addition to the resources available to visitors whose interest is aroused by the rebuilt Globe (which does not occupy its original site).

There is a plan to reconstruct the Rose, although this will be several thousand miles away in Lenox, Massachusetts. A local group, Shakespeare & Company, has engaged Jon Greenfield, an architect who worked on the Globe, to design a theatre based as closely as possible on what can be deduced from the Rose archaeology. It is one of a handful of Elizabethan theatres, both existing and proposed, in America. They include an ambitious scheme for a New Globe to be constructed inside Castle Williams on Governors Island, off the southern tip of Manhattan.

Foster and Partners, a well known British firm of architects, has designed a distinctive modern building that incorporates the principles of the Elizabethan amphitheatres, including standing room for the groundlings. Early next year the National Parks Service is due to decide whether to give the project the go-ahead. San Diego already has a Globe “less rigidly tied to the original than London's” and in 2001 a reconstructed Blackfriars, based on the incomplete evidence available, opened in Staunton, Virginia. An indoor version of the Globe has been operating for some years in Tokyo. Suddenly, all the world's an apron stage.

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The Aventis prize

May 19th 2005
From The Economist print edition

WHAT do boiling water, snowflakes and flocking birds have in common with the way we pass each other on the pavement? Philip Ball's wonderfully intricate "Critical Mass: How One Thing Leads to Another" (Farrar, Straus and Giroux; William Heinemann), which won this year's Aventis prize for science books, investigates how different thinkers, from Thomas Hobbes and Adam Smith on, have tried to explain social behaviour by applying formulas borrowed from physics. Using numerous detailed examples, Mr Ball shows just how much we can understand when we stop trying to predict the behaviour of individuals and look instead to the impact of thousands or millions of individual human decisions. "Critical Mass" is an intellectual roller-coaster; think of it next time you buy the new Harry Potter, vote for a particular party or succumb to advertising.

Vismedia

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New fiction

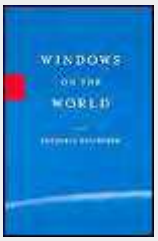
The unbearable brightness of seeing

May 19th 2005
From The Economist print edition

CONTEMPORARY authors are in a bind, as Frédéric Beigbeder identifies. It is impossible to write about the World Trade Centre attacks and impossible to write about anything else. Novelists who dodge September 11th are doomed to feel cowardly; novelists who take it on are doomed to failure.

Given the poor odds, Mr Beigbeder's “Windows on the World” is a remarkable achievement. The novel, which came out in France in 2003, is elegiac, glancing and suitably embarrassed: “In leaning on the first great hyper-terrorist attack, my prose takes on a power it would not otherwise have. This novel uses tragedy as a literary crutch.” The author even imports a nervous waggishness, though without giving offence. When before the attacks a huffy Windows restaurant patron is ejected with his lit cigar, the author cracks: “They should put a new health warning on cigarette packs: smoking can cause you to leave buildings before they blow up.”

Windows on the World.
By Frédéric Beigbeder



Miramax; 320 pages; $24.95.

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Each short chapter is titled with a time, starting at 8.30am, 15 minutes before the first Boeing struck the North Tower with the lavish restaurant on top, and ending at 10.29am, with its collapse. Chapters are alternately narrated by Mr Beigbeder himself, ruminating on what it all means, first from his native Paris, then on a pilgrimage to New York, and by a fictional Texan ad-man who has brought his two young sons to the restaurant for breakfast. Rueful, self-disgusted and yearning, character and author blend into one voice.

In contrast to the gimmicky “Extremely Loud and Incredibly Close” by Jonathan Safran Foer, Mr Beigbeder does not distract from the main event with damp-squib special effects. He may employ the odd photo or other device, but formal invention is meant to convey the inadequacy of formal invention, not to show off. He dares to approximate what it might have been like to go straight from trying to get your kids to stop bickering to trying to keep your kids from immolating, and with vivid sensory detail. Moreover, this novel is steeped in both humility and deep affection for America. Now that the international sympathy that the attacks first generated seems to have run dry, many Americans will find this foreigner's fresh grief and incredulity a welcome relief.

By Frédéric Beigbeder.
Miramax; 320 pages; $24.95.
To be published in Britain by Fourth Estate in September

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About sponsorship

Obituary

Zhang Chunqiao

May 19th 2005
From The Economist print edition

AP

Zhang Chunqiao, a member of the Gang of Four, died on April 21st, aged 88

IT TOOK almost three weeks for China's state news agency to announce the death of Zhang Chunqiao. When it came, a mere four sentences described his career as “one of the culprits of the Lin Bao and Jiang Qing Counter-revolutionary Clique”. And that, indeed, was how most Chinese had last seen him, at his televised show-trial in 1981. Manacled, rumpled, with his spectacles askew, he had looked both pathetic and desperate. And no wonder. With the other members of the Gang of Four, Mao Zedong's chief henchmen (only one of whom now survives), he had faced charges of ultimate responsibility for the persecution of 729,511 people, and the deaths of 34,800 of them, during the Cultural Revolution of 1966-76.

Mr Zhang, though prickly, had been a witty and articulate public speaker, with a disarming habit—in the middle of rants against “capitalist-roaders” and “bourgeois remnants”—of fishing cigarettes out of his pocket and lighting up. At his trial, he acquired the habit of silence. He did not respond when the judge harangued him, would look at none of the evidence against him, and pretended to go to sleep. Sentenced to death, he said nothing. When the sentence was commuted to 18 years, rumour had it that he never spoke a word in jail and lost the power of speech. He was released in 1998, but no one knew where he had gone to live. Small wonder, then, that his death was murmured of in 1991, 1994 and 1996, and that many Chinese were shocked to find that he still survived.

Suppressing words, either written or spoken, had formed the base of his career. As deputy head of the Cultural Revolution Group, from 1966 onwards, his role was to purge the party ranks of artists and intellectuals, creating instead “new-born things” that would be worthy of the revolution. Intellectuals were sent to work in the fields to clear their minds of bourgeois notions. As head of the Revolutionary Committee in Shanghai Mr Zhang used the Red Guards, ruthless gangs of students and workers, to burn books.

Having purged these “poisonous weeds” (a favourite phrase), Mr Zhang thrust in his own ideas. Even in a Maoist context, these were often extreme. He imagined a China completely free of hierarchies,

employers, wage systems, private property and even government. In 1958, Mao himself implicitly criticised his demand for the abolition of wages. One remark for which he is still remembered, “Socialist weeds are more fragrant than capitalist grain”, summed up his recklessness. He showed more enthusiasm than most, too, for the bowdlerising of the Beijing Opera under Mao's fourth wife, Jiang Qing, the leader of the Gang. Her masterwork, “Spark Amid the Reeds”, underwent ten rewrites by Mr Zhang to make it into a thing of revolutionary glory.

His most daring idea concerned Shanghai itself. In 1967 he sought to turn China's most westernised, industrialised city into a version of the Paris commune of 1870-71. The bureaucrats were kicked out, and the masses took over the government. Their slogan was “overthrow everything”. Unfortunately, dissident elements turned off the water and the power, and the city ground almost to a halt. Mao summoned Mr Zhang to Beijing and reined him back. Most painful of all, he condemned his efforts as “reactionary”.

The iron broom

Like many an iconoclast, Mr Zhang's roots lay in the things he despised. His family were landlords and intellectuals in Shandong province, and he went to a good school. He joined the Chinese League of Left-Wing Writers as a teenager, objecting to the regime of Chiang Kai-shek, and was a communist by 1940, when he was 23. His commitment to the cause was solid by 1949, when he followed the victorious communist army into Shanghai.

Unswerving though he seemed, he occasionally doubted that China's revolution could be as swift and total as he hoped. His most famous article, “On Exercising All-Round Dictatorship over the Bourgeoisie” (1975), admitted that the abolition of private property, money and material incentives could take a little time. He hoped, however, that the “fortified villages” held by the bourgeoisie would be swept away, one by one, by the “iron broom of the proletariat”. Deng Xiaoping's proposals to increase exports he scorned as “nation-selling capitulationism”.

By then, though he had risen to second vice-premier, Mr Zhang could feel the forces of reaction closing in. In a rare candid note, written that February, he admitted that he thought he might be beheaded “at any time”. In fact the denouement happened in October 1976, when an elite unit of the People's Liberation Army arrested him, Madame Mao, and the two others who made up the “Gang of Four”, Yao Wenyuan and Wang Hongwen.

Mao was then a month dead. His star burned bright for two more years, then waned. By 1980, Mr Zhang and the others were scapegoats for his enormities. They were scapegoats, too, for the millions of Chinese who had helped to drive out neighbours, or chastise intellectuals, or hound local bureaucrats from office in the fervid days of Maoist upheaval. Mr Zhang's guilty silence in court was not only his, but theirs. It is a silence that China still finds exceedingly hard to break.

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Overview

May 19th 2005
From The Economist print edition

The **dollar** reached its highest level against the euro for almost seven months on May 13th: one euro cost just over $1.26. The dollar kept its strength despite a Treasury report showing that foreigners' appetite for American assets ebbed in March. Net foreign purchases of long-term American securities amounted to $45.7 billion in March, compared with $84.1 billion in February.

Japan's GDP grew at an annual rate of 5.3% in the first quarter, according to preliminary estimates, much faster than expected. A large part of this growth was due to a surge in consumer spending. The GDP deflator, a broad measure of prices, fell by 1.2% compared with a year before. Industrial production expanded by 1.2% in the year to March.

Both hawks and doves found evidence for their case in **America's inflation** figures. Producer prices rose by 0.6% in April, somewhat faster than expected. Consumer prices increased by 0.5% in the same month, leaving them 3.5% higher than a year before. But core consumer prices, which exclude the volatile categories of food and energy, were unchanged in April from the month before.

The strength of economic activity in **America** was also hard to gauge. Industrial production fell by 0.2% in April, though it remained 3.1% higher than a year ago. Housing starts bounced back, with construction beginning on more than 2m homes in April, after 1.84m the month before. The value of retail sales increased by 1.4% in April, the strongest rise since September.

The **euro area** grew at an annualised rate of 2.0% in the first quarter. But **Italy** sank into recession. Its GDP shrank at an annual rate of 1.8% in the first quarter, having contracted by the same amount in the last three months of 2004.

Germany registered a welcome bounce, growing at an annual rate of 4.1% in the first quarter, thanks to a strong trade performance. In the **Netherlands**, GDP contracted at an annual rate of 0.6% in the same period, after falling by 0.2% the quarter before.

In **Britain**, consumer prices increased by 1.9% in the year to April, having increased at the same pace in the year to March. Average earnings rose by 4.6% in the year to the first quarter. The unemployment rate edged downwards to 4.7% in March.

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Output, demand and jobs

May 19th 2005
From The Economist print edition

% change on year ago

	GDP latest		GDP qtr*	The Economist poll GDP forecasts 2005	2006	Industrial production latest		Retail sales (volume) latest		Unemployment % rate latest		year ago
Australia	+ 1.5	Q4	+ 0.6	+ 2.5	+ 3.2	– 0.4	Q4	+ 1.8	Q1	5.1	Apr	5.6
Austria	+ 2.1	Q4	+ 1.1	+ 2.0	+ 2.0	+ 4.4	Feb	+ 0.8	Feb	4.6	Apr	4.5
Belgium	+ 1.8	Q1	nil	+ 2.0	+ 2.2	– 5.9	Mar	– 2.8	Feb	12.3	Apr†	12.4
Britain	+ 2.8	Q1	+ 2.2	+ 2.4	+ 2.2	– 1.8	Mar	+ 2.3	Apr	4.7	Mar††	4.8
Canada	+ 3.0	Q4	+ 1.7	+ 2.7	+ 3.0	+ 3.8	Feb	+ 6.3	Feb	6.8	Apr	7.2
Denmark	+ 2.9	Q4	+ 3.2	+ 2.1	+ 2.2	– 4.5	Mar	+ 3.7	Mar	5.9	Mar	6.5
France	+ 2.3	Q4	+ 3.5	+ 1.9	+ 2.0	– 0.5	Mar	+ 1.5	Mar	10.2	Mar	10.0
Germany	+ 1.0	Q1	+ 4.1	+ 0.9	+ 1.5	+ 1.6	Mar	nil	Mar	11.8	Apr§	10.5
Italy	– 0.2	Q1	– 1.8	+ 0.8	+ 1.4	– 2.9	Mar	– 0.8	Feb	8.0	Dec	8.2
Japan	+ 1.2	Q1	+ 5.3	+ 1.1	+ 1.8	+ 1.2	Mar	+ 0.7	Mar	4.5	Mar	4.7
Netherlands	– 0.3	Q1	– 0.6	+ 1.1	+ 1.7	– 2.9	Mar	– 2.7	Feb‡	6.6	Apr**	6.4
Spain	+ 2.7	Q4	+ 3.4	+ 2.7	+ 2.6	– 6.5	Mar	+ 1.8	Mar	10.2	Mar	11.1
Sweden	+ 2.0	Q4	+ 1.4	+ 2.8	+ 2.8	+ 4.4	Mar	+ 8.0	Mar	5.5	Mar†	5.8
Switzerland	+ 1.2	Q4	– 0.3	+ 1.2	+ 1.7	+ 4.7	Q4	– 0.3	Mar	3.8	Apr†	3.9
United States	+ 3.6	Q1	+ 3.1	+ 3.5	+ 3.2	+ 3.1	Apr	+ 3.0	Mar	5.2	Apr	5.5
Euro area	+ 1.4	Q1	+ 2.0	+ 1.4	+ 1.8	+ 0.6	Feb	+ 1.4	Mar	8.9	Mar	8.8
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*											
Finland	+ 3.6	Q4	+ 2.5	na	na	+ 1.1	Mar	+ 2.9	Mar	8.5	Mar†	9.5
Greece	+ 3.6	Q1	na	na	na	– 4.9	Mar	– 2.9	Jan	10.2	Dec	9.8
Iceland	+ 3.8	Q4	na	na	na	na		na		2.6	Mar†	3.5
Ireland	+ 2.8	Q4	na	na	na	– 3.4	Mar	+ 8.6	Feb	4.2	Apr	4.6
Luxembourg	+ 3.8	Q4	nil	na	na	+ 6.3	Feb	+ 2.6	Mar	4.6	Mar	4.2
New Zealand	+ 3.6	Q4	+ 2.4	na	na	+ 3.5	Q4	+ 5.8	Q1	3.9	Q1	4.2
Norway	+ 3.2	Q4	+ 6.1	na	na	– 7.0	Mar	– 2.7	Mar	4.5	Mar‡**	4.3
Portugal	+ 0.6	Q4	– 1.1	na	na	– 3.2	Mar	+ 3.0	Mar	7.5	Q1†	6.4

*% change on previous quarter at an annual rate. †Not seasonally adjusted. ‡New series. ††Jan-Mar; claimant count rate 2.7% in Apr. §EU harmonised rate 9.5% in Mar. **Feb-Apr.

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Prices and wages

May 19th 2005
From The Economist print edition

% change on year ago

	Consumer prices			The Economist poll consumer prices forecast		Producer prices			Wages/earnings		
	latest		year ago	2005	2006	latest		year ago	latest		year ago
Australia	+ 2.4	Q1	+ 2.0	+ 2.6	+ 2.7	+ 6.0	Q1	– 1.1	+ 3.0	Q4	+ 6.0
Austria	+ 2.6	Apr	+ 1.6	+ 2.0	+ 1.6	+ 2.6	Apr	+ 5.2	+ 2.2	Apr	+ 2.2
Belgium	+ 2.8	Apr	+ 1.9	+ 1.9	+ 1.7	+ 3.8	Mar	+ 2.3	+ 2.3	Jan	+ 1.9
Britain	+ 1.9	Apr*	+ 1.2	+ 1.8	+ 1.9	+ 3.2	Apr	+ 1.8	+ 4.6	Mar†	+ 5.1
Canada	+ 2.3	Mar	+ 0.7	+ 2.0	+ 2.1	+ 2.1	Mar	– 0.8	+ 2.5	Feb	+ 3.5
Denmark	+ 1.8	Apr	+ 0.8	+ 1.4	+ 1.7	+ 3.8	Apr	+ 1.6	+ 2.8	Q4	+ 3.5
France	+ 1.8	Apr	+ 2.1	+ 1.6	+ 1.6	+ 3.1	Mar	+ 0.3	+ 2.9	Q1	+ 2.8
Germany	+ 1.6	Apr	+ 1.6	+ 1.4	+ 1.1	+ 3.2	Apr	+ 2.4	+ 1.5	Mar	+ 1.5
Italy	+ 1.9	Apr	+ 2.3	+ 1.9	+ 1.9	+ 4.6	Mar	+ 0.7	+ 3.5	Mar	+ 2.8
Japan	– 0.2	Mar	– 0.1	nil	+ 0.3	+ 1.8	Apr	+ 0.6	+ 0.7	Mar	+ 2.2
Netherlands	+ 1.5	Apr	+ 1.4	+ 1.4	+ 1.0	+ 4.9	Mar	– 0.2	+ 0.7	Apr	+ 1.6
Spain	+ 3.5	Apr	+ 2.7	+ 2.9	+ 2.6	+ 5.1	Mar	+ 0.8	+ 2.6	Q4	+ 3.3
Sweden	+ 0.3	Apr	+ 0.3	+ 0.6	+ 1.5	+ 2.5	Mar	– 1.4	+ 2.6	Feb	+ 3.0
Switzerland	+ 1.4	Apr	+ 0.5	+ 1.2	+ 1.2	+ 1.3	Apr	+ 0.7	+ 0.9	2004	+ 1.4
United States	+ 3.5	Apr	+ 2.3	+ 2.8	+ 2.5	+ 4.8	Apr	+ 3.7	+ 2.7	Apr	+ 2.2
Euro area	+ 2.1	Apr	+ 2.0	+ 1.8	+ 1.6	+ 4.2	Mar	+ 0.4	+ 2.2	Q4	+ 2.1
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*										
Finland	+ 1.2	Apr	– 0.4	na	na	+ 3.1	Apr	+ 0.5	+ 3.0	Q4	+ 4.2
Greece	+ 3.4	Apr	+ 2.9	na	na	+ 4.7	Mar	+ 2.1	na		na
Iceland	+ 2.9	May	+ 3.2	na	na	+ 6.6	Apr	+ 2.7	+ 6.5	Mar	+ 3.8
Ireland	+ 2.2	Apr	+ 1.4	na	na	– 2.3	Mar	– 5.1	+ 5.1	Q4	+ 4.5
Luxembourg	+ 2.5	Apr	+ 2.1	na	na	+16.3	Feb	– 0.6	+ 0.6	Feb	+ 4.0
New Zealand	+ 2.8	Q1	+ 1.5	na	na	+ 3.4	Q4	– 0.1	+ 2.5	Q1	+ 2.2
Norway	+ 1.1	Apr	+ 0.4	na	na	+17.5	Apr	+12.3	+ 3.9	Q4	+ 3.9
Portugal	+ 2.1	Apr	+ 2.3	na	na	+ 4.7	Mar	+ 0.3	– 4.0	Mar	+ 1.9

*RPI inflation rate 3.2% in Apr. †Jan-Mar.

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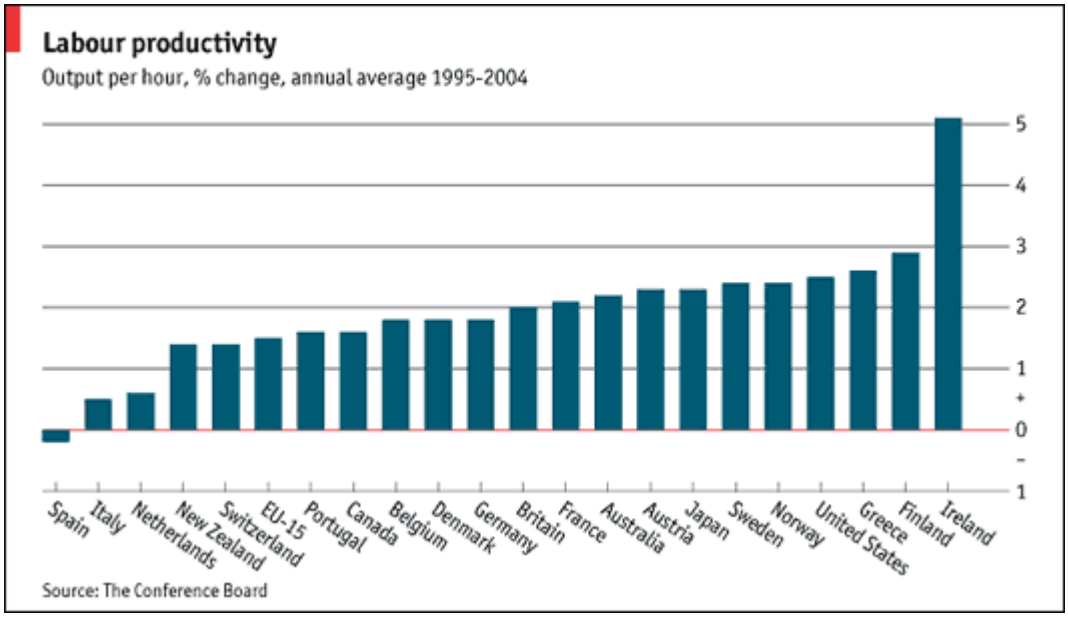
Labour productivity

May 19th 2005
From The Economist print edition



Since 1995, labour productivity in America has grown by 2.5% a year. This is a striking improvement on previous performance, and owes much to advances in information technology (IT). Most big European economies have failed, so far, to match America's record in using IT to boost efficiency. Far from accelerating, productivity growth in the EU-15 has decelerated to 1.5% a year over the same period.

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Money and interest rates

May 19th 2005
From The Economist print edition

	Money supply* % change on year ago			Interest rates % a year (May 18th 2005)					
				3-mth money market		2-year	10-year gov't bonds		corporate
	narrow	broad		latest	year ago	gov't bonds	latest	year ago	bonds
Australia	+ 2.8	+ 8.2	Mar	5.67	5.49	5.18	5.28	6.04	6.36
Britain	+ 5.1	+10.3	Mar	4.81	4.50	4.28	4.34	5.14	5.21
Canada	+11.8	+10.8	Mar	2.45	2.02	3.02	4.08	5.14	5.55
Denmark	+15.6	+ 9.5	Mar	2.18	2.25	2.20	3.31	4.48	4.92
Japan	+ 4.6	+ 1.9	Apr	0.02	0.02	0.10	1.28	1.50	1.39
Sweden	+ 3.3	+ 3.6	Mar	1.85	1.95	2.12	3.23	4.69	2.97
Switzerland	– 7.1	+ 2.1	Apr	0.75	0.26	1.00	2.03	2.72	2.01
United States	+ 2.0	+ 4.5	Apr	3.17	1.09	3.55	4.09	4.78	5.17
Euro area†	+ 9.3	+ 6.5	Mar	2.13	2.09	2.21	3.25	4.28	3.83

*Narrow: M1 except Britain and Sweden M0, broad: M2 or M3 except Britain M4. †Germany for bonds. Benchmarks: US 30-year 4.44%, Japan No. 269 1.27%. Central bank rates: US fed funds 3.00%, ECB refinancing 2.00%, BOJ overnight call 0.001%, BOE repo 4.75%. Sources: Bank of Canada, Commerzbank, Danske Bank, J.P. Morgan Chase, Stockholmsbörsen, UBS, Global Insight, Westpac, Thomson Datastream. Rates cannot be construed as banks' offers.

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The Economist commodity price index

May 19th 2005
From The Economist print edition

2000=100

	May 10th	May 17th*	% change on one month	% change on one year
Dollar index				
All items	132.5	129.8	– 2.9	– 1.8
Food	127.6	125.4	– 1.7	– 8.2
Industrials				
All	139.0	135.5	– 4.4	+ 7.1
Nfa†	128.1	127.9	– 1.6	–10.3
Metals	144.9	139.7	– 5.7	+18.5
Sterling index				
All items	106.7	107.0	+ 1.1	– 5.5
Euro index				
All items	95.2	95.0	+ 0.2	– 7.1
Yen index				
All items	129.8	129.1	– 2.8	– 7.9
Gold				
$ per oz	427.70	420.73	– 2.7	+11.5
West Texas Intermediate				
$ per barrel	51.88	48.92	– 6.4	+21.1

* Provisional. † Non-food agriculturals.

Our commodity-price index was rebased in February 2005.

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Stockmarkets

May 19th 2005
From The Economist print edition

Market indices

	May 18th	2005 high	2005 low	% change on one week	% change on record high	% change on Dec 31st 2004 in local currency	% change on Dec 31st 2004 in $ terms
Australia (All Ordinaries)	3,940.5	4,255.8	3,905.5	– 0.5	– 7.4	– 2.8	– 6.0
Austria (ATX)	2,609.4	2,781.6	2,415.0	+ 0.6	– 6.2	+ 7.3	– 0.2
Belgium (Bel 20)	3,054.4	3,197.3	2,958.8	– 0.2	–17.0	+ 4.2	– 3.2
Britain (FTSE 100)	4,949.4	5,060.8	4,783.6	+ 1.5	–28.6	+ 2.8	– 1.8
Canada (Toronto Composite)	9,407.8	9,927.2	9,006.2	– 0.4	–17.4	+ 1.7	– 3.4
Denmark (KBX)	287.7	294.6	257.8	+ 0.1	– 4.7	+11.6	+ 3.7
France (SBF 250)	2,815.3	2,855.6	2,633.6	+ 2.2	–35.9	+ 6.9	– 0.6
(CAC 40)	4,073.2	4,124.4	3,816.1	+ 2.4	–41.2	+ 6.6	– 0.9
Germany (DAX)*	4,324.6	4,428.1	4,178.1	+ 1.9	–46.4	+ 1.6	– 5.5
Italy (S&P/MIB)	31,567.0	32,856.0	30,645.0	+ 1.4	–37.0	+ 2.1	– 5.0
Japan (Nikkei 225)	10,835.4	11,966.7	10,825.4	– 2.6	–72.2	– 5.7	– 9.9
(Topix)	1,109.2	1,203.3	1,109.2	– 3.2	–61.6	– 3.5	– 7.8
Netherlands (AEX)	361.0	379.8	347.0	+ 2.3	–48.5	+ 3.7	– 3.6
Spain (Madrid SE)	1,008.7	1,025.8	950.9	+ 2.2	–12.0	+ 5.2	– 2.2
Sweden (Affarsvarlden Gen)	234.0	240.4	218.9	+ 2.6	–41.6	+ 5.8	– 2.3
Switzerland (Swiss Market)	5,996.9	6,030.5	5,669.6	+ 1.3	–28.7	+ 5.3	– 1.9
United States (DJIA)	10,464.5	10,940.6	10,012.4	+ 1.6	–10.7	– 3.0	– 3.0
(S&P 500)	1,185.6	1,225.3	1,137.5	+ 1.2	–22.4	– 2.2	– 2.2
(NASDAQ Comp)	2,030.7	2,152.2	1,904.2	+ 3.0	–59.8	– 6.7	– 6.7
Europe (FTSEurofirst 300)†	1,087.3	1,107.6	1,038.6	+ 1.4	–36.2	+ 4.4	– 3.0
Euro area (FTSE Euro 100)†	925.9	952.4	894.4	+ 2.0	–40.3	+ 2.8	– 4.4
World (MSCI)‡	1,135.0	1,193.0	1,115.0	+ 0.2	–21.7	– 2.9	– 2.9
World bond market (Citigroup)††	650.6	662.3	642.6	– 0.9	– 1.8	– 2.3	– 2.3

*Total return index. †In euro terms. ‡Morgan Stanley Capital International index includes individual markets listed above plus eight others, in $ terms. ††Citigroup World Government Bond Index, total return, in $ terms.

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Trade, exchange rates and budgets

May 19th 2005
From The Economist print edition

	Trade balance*, $bn latest 12 months		Current-account balance $bn latest 12 mths		The Economist poll % of GDP, forecast 2005	2006	Exchange rate trade-weighted† 2000=100 May 18th	year ago	Currency units per $ May 18th	year ago	per £	per euro	per ¥100	Budget balance % of GDP 2005‡
Australia	− 18.3	Mar	− 39.4	Q4	− 5.6	− 5.0	114.5	110.4	1.32	1.43	2.42	1.67	1.23	+ 0.4
Austria	− 0.1	Feb	− 0.9	Feb	− 0.6	− 0.8	106.0§	106.0	0.79	0.83	1.45	–	0.74	− 2.1
Belgium	+ 15.7	Mar	+ 12.0	Dec	+ 3.4	+ 3.3	108.0§	106.5	0.79	0.83	1.45	–	0.74	− 0.4
Britain	−108.9	Mar	− 49.0	Q4	− 2.6	− 2.6	99.4	100.6	0.55	0.56	–	0.69	0.51	− 3.2
Canada	+ 49.4	Mar	+ 23.4	Q4	+ 1.8	+ 1.5	113.8	105.3	1.26	1.38	2.32	1.60	1.18	+ 1.2
Denmark	+ 9.3	Mar	+ 7.4	Mar	+ 2.2	+ 2.1	106.3	105.8	5.89	6.18	10.8	7.45	5.50	+ 1.4
France	− 18.9	Mar	− 10.9	Mar	− 0.3	− 0.1	108.9§	107.3	0.79	0.83	1.45	–	0.74	− 3.1
Germany	+199.4	Mar	+109.0	Mar	+ 3.1	+ 2.9	110.6§	108.7	0.79	0.83	1.45	–	0.74	− 3.5
Italy	− 4.6	Mar	− 16.8	Feb	− 1.0	− 1.1	108.5§	107.0	0.79	0.83	1.45	–	0.74	− 3.1
Japan	+125.9	Mar	+170.1	Mar	+ 3.6	+ 3.6	88.1	85.7	107	113	197	135	–	− 6.4
Netherlands	+ 38.6	Mar	+ 33.9	Q1	+ 3.5	+ 3.5	108.8§	107.3	0.79	0.83	1.45	–	0.74	− 2.7
Spain	− 79.9	Feb	− 55.5	Feb	− 4.9	− 5.0	106.2§	106.1	0.79	0.83	1.45	–	0.74	− 0.1
Sweden	+ 23.0	Mar	+ 28.0	Q4	+ 7.0	+ 6.4	98.3	98.7	7.19	7.56	13.2	9.09	6.71	+ 0.7
Switzerland	+ 7.0	Mar	+ 40.8	Q4	+11.9	+11.4	107.5	107.4	1.22	1.28	2.24	1.54	1.14	− 0.6
United States	−700.9	Mar	−665.9	Q4	− 6.2	− 6.0	84.3	89.2	–	–	1.83	1.26	0.93	− 4.1
Euro area	+ 82.0	Feb	+ 50.6	Feb	+ 0.5	+ 0.5	117.3	115.1	0.79	0.83	1.45	–	0.74	− 2.6
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*													
Finland	+ 13.1	Mar	+ 7.9	Mar	na	na	109.5§	108.2	0.79	0.83	1.45	–	0.74	+ 2.1
Greece	− 32.6	Feb	− 9.6	Feb	na	na	105.1§	104.1	0.79	0.83	1.45	–	0.74	− 3.5
Iceland	− 0.7	Mar	− 1.0	Q4	na	na	99.2**	93.0	65.3	73.2	120	82.6	60.9	+ 1.2
Ireland	+ 40.6	Mar	− 0.8	Q4	na	na	114.8§	111.9	0.79	0.83	1.45	–	0.74	− 0.1
Luxembourg	− 4.6	Feb	+ 2.9	Q4	na	na	108.0§	106.5	0.79	0.83	1.45	–	0.74	− 0.8
New Zealand	− 3.0	Mar	− 6.2	Q4	na	na	136.5	122.2	1.41	1.65	2.58	1.78	1.31	+ 2.1
Norway	+ 40.9	Apr	+ 34.4	Dec	na	na	108.2	104.9	6.41	6.88	11.8	8.10	5.98	+ 10.5
Portugal	− 19.2	Feb	− 13.6	Feb	na	na	105.8**	105.2	0.79	0.83	1.45	–	0.74	− 3.0

*Merchandise. Australia, Britain, France, Canada, Japan and United States imports fob, exports fob. All others cif/fob. †Bank of England except §IMF, March average. ‡OECD forecast. ††New series. **IMF, January average.

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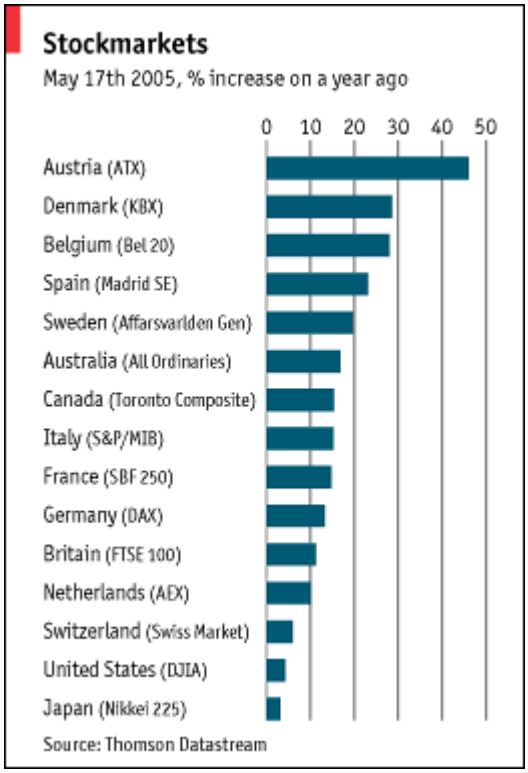
Stockmarkets

May 19th 2005
From The Economist print edition



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Overview

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China's industrial production rose by 16% in the year to April, faster than expected. But consumer-price inflation slowed to 1.8% over the same period, easing one of the domestic pressures for a currency revaluation.

India's trade deficit swelled to $3.9 billion in April.

Indonesia's economy grew by 6.4% in the year to the first quarter.

Industrial output in **Mexico** fell by 4.7% in the year to March, the first drop in output year-on-year since November 2003.

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The Economist poll of forecasters

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Every three months, *The Economist* polls a group of forecasters and averages their predictions for growth and current-account balances in 25 emerging economies. Compared with February, our seers have become more optimistic, raising their projections for GDP growth this year in 14 countries and lowering them in six. They have become particularly bullish on Argentina, raising that country's projected growth rate to 6.7%. Three months ago they expected Argentina to grow by 5.3%.

May

	Real GDP % change		Current account % of GDP	
	2005	2006	2005	2006
China	8.7	8.0	4.1	3.2
Hong Kong	4.6	4.6	9.3	8.6
India	6.7	6.8	−1.0	−1.0
Indonesia	5.1	5.5	0.8	0.4
Malaysia	4.8	5.3	11.1	9.8
Philippines	4.7	5.0	2.3	1.8
Singapore	3.8	4.7	25.1	23.7
South Korea	3.6	4.5	3.3	2.1
Taiwan	4.1	4.2	5.4	5.0
Thailand	4.8	5.6	1.9	1.5
Argentina	6.7	3.8	1.5	0.5
Brazil	3.7	3.7	0.9	0.3
Chile	5.8	5.0	0.7	−0.2
Colombia	3.7	3.4	−1.9	−2.1
Mexico	3.9	3.4	−1.7	−2.1
Peru	4.5	4.0	−0.1	−0.7
Venezuela	5.6	4.2	11.2	6.2
Egypt	4.3	4.8	4.0	1.8
Israel	4.1	4.0	−0.5	−0.7
South Africa	4.0	3.8	−3.3	−3.3
Czech Republic	4.1	4.1	−4.5	−4.5
Hungary	3.5	3.7	−8.3	−8.2
Poland	4.3	4.5	−1.8	−2.4
Russia	6.0	5.2	8.5	5.4
Turkey	5.7	5.3	−4.8	−4.6

Sources: ABN Amro; Deutsche Bank; Economist Intelligence Unit; Goldman Sachs; HSBC; ING Financial Markets; J.P. Morgan Chase; Citigroup; UBS.

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Economy

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	% change on year ago						Latest 12 months, $bn				Foreign reserves* $bn, latest	
	GDP		Industrial production		Consumer prices		Trade balance		Current account			
China	+ 9.5	Q1	+16.0	Apr	+ 1.8	Apr	+64.1	Apr	+68.7	2004	659.1	Mar
Hong Kong	+ 7.1	Q4	+ 5.0	Q4	+ 0.8	Mar	−11.0	Mar	+16.0	Q4	122.6	Apr
India	+ 6.2	Q4	+ 7.2	Mar	+ 4.2	Mar	−28.9	Apr	− 3.9	Q4	136.0	Apr
Indonesia	+ 6.4	Q1	− 5.7	Jan	+ 8.1	Apr	+27.4	Mar	+ 2.9	Q4	34.7	Mar
Malaysia	+ 5.6	Q4	+ 5.0	Mar	+ 2.7	Apr	+22.8	Mar	+15.1	Q4	71.7	Mar
Philippines	+ 5.4	Q4	+ 2.4	Feb	+ 8.5	Apr	− 0.1	Feb	+ 2.1	Dec	14.1	Apr
Singapore	+ 2.5	Q1	+ 8.3	Mar	+ 0.4	Mar	+15.9	Apr	+29.2	Q1	116.6	Apr
South Korea	+ 3.3	Q4	+ 4.8	Mar	+ 3.1	Apr	+28.8	Apr	+27.5	Mar	206.3	Apr
Taiwan	+ 3.3	Q4	− 0.8	Mar	+ 1.6	Apr	+ 3.6	Apr	+19.0	Q4	252.6	Apr
Thailand	+ 5.1	Q4	+ 7.1	Mar	+ 3.6	Apr	− 1.8	Mar	+ 3.6	Apr	47.7	Mar
Argentina	+ 8.4	Q4	+ 5.4	Mar	+ 8.8	Apr	+11.7	Mar	+ 3.0	Q4	19.6	Mar
Brazil	+ 4.9	Q4	+ 1.7	Mar	+ 8.1	Apr	+37.8	Apr	+12.7	Mar	61.5	Mar
Chile	+ 7.3	Q4	+ 2.3	Mar	+ 2.9	Apr	+ 9.1	Apr	+ 1.4	Q4	15.4	Mar
Colombia	+ 4.3	Q4	nil	Feb	+ 5.0	Apr	+ 0.9	Dec	− 1.1	Q4	13.1	Apr
Mexico	+ 2.4	Q1	− 4.7	Mar	+ 4.6	Apr	− 9.9	Mar	− 8.7	Q4	64.1	Mar
Peru	+ 4.0	Mar	+ 2.1	Mar	+ 2.0	Apr	+ 3.2	Mar	− 0.1	Q4	13.6	Mar
Venezuela	+11.2	Q4	+ 9.5	Feb	+15.8	Apr	+22.1	Q4	+14.6	Q4	19.1	Feb
Egypt	+ 4.7	Q4	+ 3.3	2004†	+ 6.8	Feb	− 9.0	Q4	+ 4.3	Q4	16.4	Mar
Israel	+ 4.8	Q4	+ 2.2	Feb	+ 0.3	Apr	− 7.0	Apr	+ 0.5	Q4	26.7	Apr
South Africa	+ 4.7	Q4	+ 1.2	Mar	+ 3.0	Mar	− 2.7	Mar	− 7.0	Q4	14.3	Apr
Czech Republic	+ 4.3	Q4	+ 0.1	Mar	+ 1.6	Apr	+ 0.1	Mar	− 5.6	Q4	27.8	Apr
Hungary	+ 3.8	Q4	+ 3.9	Mar	+ 3.9	Apr	− 2.9	Q4	− 8.8	Q4	17.3	Apr
Poland	+ 3.9	Q4	− 3.7	Mar	+ 3.0	Apr	− 4.9	Feb	− 3.2	Feb	36.8	Mar
Russia	+ 4.9	Q1	+ 5.0	Apr	+13.4	Apr	+97.6	Mar	+60.1	Q4	140.5	Apr
Turkey	+ 6.3	Q4	+ 5.5	Mar	+ 8.2	Apr	−35.9	Mar	−16.5	Mar	38.1	Mar
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*											
Estonia	+ 5.8	Q4	+12.1	Mar	+ 4.7	Apr	− 1.7	Feb	− 1.4	Q4	1.9	Mar
Latvia	+ 8.6	Q4	+ 0.8	Mar	+ 6.9	Apr	− 2.8	Mar	− 1.7	Mar	2.0	Mar
Lithuania	+ 5.5	Q1	na		+ 3.2	Apr	− 2.9	Mar	− 1.6	Q4	3.5	Mar
Slovakia	+ 5.8	Q4	− 2.2	Mar	+ 2.7	Apr	− 1.7	Mar	− 1.6	Jan	17.6	Mar
Slovenia	+ 4.3	Q4	− 3.8	Mar	+ 2.7	Apr	− 1.6	Mar	− 0.3	Mar	8.7	Feb
Pakistan	+ 6.4	2004†	+28.3	Nov	+11.1	Apr	− 6.0	Mar	− 1.5	Q1	10.7	Mar
Saudi Arabia	+ 5.3	2004	na		+ 0.5	Feb	+68.5	2004	+51.5	Jun	23.3	Mar

*Excluding gold, except Singapore; IMF definition. †Year ending June.

Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Economist Intelligence Unit; Reuters; J.P. Morgan Chase; Hong Kong Monetary Authority; Centre for Monitoring Indian Economy; FIEL; EFG-Hermes; Bank Leumi Le-Israel; Standard Bank Group; Akbank; Deutsche Bank

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Financial markets

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	Currency units			Interest rates	Stockmarkets	% change on		
	per $		per £	short-term	May 18th		Dec 31st 2004	
	May 18th	year ago	May 18th	% a year		one week	in local currency	in $ terms
China	8.28	8.28	15.2	2.50	1,157.7	– 1.9	– 13.0	– 13.0
Hong Kong	7.80	7.79	14.3	2.66	13,627.0	– 2.2	– 4.2	– 4.5
India	43.5	45.1	79.8	5.19	6,447.0	nil	– 2.4	– 2.4
Indonesia	9,450	9,050	17,336	7.94	1,040.3	– 1.6	+ 4.0	+ 2.2
Malaysia	3.80	3.80	6.97	2.83	886.4	– 1.4	– 2.3	– 2.3
Philippines	54.6	55.7	100.1	5.13	1,879.4	– 2.2	+ 3.1	+ 6.0
Singapore	1.65	1.71	3.03	2.06	2,153.7	– 0.9	+ 4.2	+ 3.0
South Korea	1,004	1,174	1,841	3.51	930.4	+ 0.8	+ 3.8	+ 7.1
Taiwan	31.3	33.4	57.5	1.40	5,890.8	– 0.4	– 4.1	– 3.0
Thailand	39.9	40.7	73.2	2.65	672.2	– 1.8	+ 0.6	– 2.0
Argentina	2.89	2.91	5.30	5.56	1,458.3	+ 4.1	+ 6.0	+ 9.1
Brazil	2.47	3.09	4.52	19.52	24,898.0	+ 0.8	– 5.0	+ 2.4
Chile	581	634	1,065	4.68	9,190.9	– 0.8	+ 2.5	– 1.9
Colombia	2,341	2,736	4,294	7.28	4,887.1	– 0.7	+ 12.5	+ 13.0
Mexico	11.0	11.5	20.1	9.73	12,727.7	+ 2.1	– 1.5	+ 0.1
Peru	3.25	3.48	5.97	2.97	3,848.1	– 0.4	+ 3.7	+ 4.6
Venezuela	2,602§	3,086§	4,774	11.23	23,547.3	– 1.4	– 21.4	– 22.1
Egypt	5.80	6.19	10.63	10.03	36,985.5	– 4.7	+ 50.4	+ 57.6
Israel	4.37	4.59	8.01	3.63	693.4	– 0.4	+ 7.7	+ 6.5
South Africa	6.42	6.72	11.8	7.05	13,268.9	+ 1.2	+ 4.8	– 8.0
Czech Republic	23.9	26.9	43.8	1.78	1,110.8	– 0.3	+ 7.6	+ 0.6
Hungary	199	210	366	7.47	16,329.9	+ 1.4	+ 10.8	+ 0.4
Poland	3.31	3.74	6.07	5.46	26,092.9	+ 1.4	– 2.0	– 11.4
Russia	28.0	30.9	51.4	13.00	647.4‡	– 2.3	+ 6.5	+ 5.4
Turkey	1.37	1.50	2.51	16.73	25,205.5	+ 2.2	+ 0.9	– 0.7
EM (MSCI)*	1.00	1.00	1.83	na	540.5	– 0.5	– 0.3	– 0.3
EMBI+†	1.00	1.00	1.83	na	335.2	+ 0.6	+ 1.7	+ 1.7

*Emerging Mkts. †J.P. Morgan Chase's Emerging Mkts Bond Index Plus. ‡In $ terms. §Floating exchange rate.

Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Economist Intelligence Unit; Reuters; J.P. Morgan Chase; Hong Kong Monetary Authority; Centre for Monitoring Indian Economy; FIEL; EFG-Hermes; Bank Leumi Le-Israel; Standard Bank Group; Akbank; Deutsche Bank

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